THE MONETARY SYSTEM OF INDIA

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By

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PREFACE

THE matter and form of this book should have appeared quite differently. Two factors, however, perforce have contributed to its transformation into its present shape. Firstly, the Paper Control Regulations permit the publication of a Volume which is of prime importance to students of Universities ; and very rightly so under the present conditions of acute paper scarcity. Secondly, Professors of various Universities have from time to time asked the writer to restore to the public a publication which had become but a relic during the years of World War II.

It is hoped that in its new garb this work may prove valuable to Collegiate students, in particular to those preparing for the Bachelor of Commerce Degree of various Universities. In its present form, it is respectfully maintained that it is also well calculated to meet the wants and appeal to the judgment of businessmen and financiers.

The writer's sincere thanks are due to Rev. Father A. J. S. Monteiro, Principal, St. John's High School, Nagpur, who read the manuscript in its entirety and made valuable suggestions.

B. E. D.

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EXPLANATION

As a guide to the reading of certain figures and weights it may be mentioned that :

(1) The Rupee is linked to Sterling at 1 Rupee = 1*s*. 6*d*.

At this rate of exchange,

1 Anna	=	1 Penny
12 Annas	=	1 Shilling
1 Rupee	=	1 Shilling and 6 Pence
13 Rupees and 5 annas	=	1 Pound

10,000 Rupees = 1 *Lakh* Rupees = £ 7,500

100 Lakhs (10 million) Rupees = 1 *Crore* Rupees = £750,000

(2) Since 1940, according to the Ordinance passed regarding Indian coinage, the weight of the silver in the Rupee has been reduced to $\frac{1}{2}$ fine instead of $\frac{11}{12}$th fine. Consequently, the weight of the silver in the Rupee is today 8 annas.

(3) The Indian Jeweller's weight of 1 *tola* is equivalent to $\frac{2}{5}$ oz.

BOOK I

CHAPTER I

The New Monetary Authority in India

The passing of the Reserve Bank of India Act, 1934, started a new era in the monetary organization of India. It constituted a Central Bank in India, named, the *Reserve Bank of India*, "*in order to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in British India and generally to operate the currency and credit system of the country to its advantage.*" The Bank was consequently installed in 1935 as the new Monetary Authority in India with a *monopoly* to issue Bank notes, at the same time, the Governor-General in Council *ceased* to issue any currency notes and handed over the management of the currency to the Bank.

The Reserve Bank of India has two Departments :—

(i) The Issue Department.

(ii) The Banking Department.

The Issue Department is separated and kept wholly distinct from the Banking Department.

(A) CO-ORDINATION OF CURRENCY AND CREDIT :— With the establishment of the Reserve Bank of India there immediately followed that co-ordination of currency and credit which was so eagerly prayed for. When a commercial bank extends its credit in the form of promises to pay to borrowers, these promises have behind them *cash* for which they will be exchanged and that is why they pass freely from hand to hand. When it accepts cheques, bills or drafts, it is because they are drawn by persons having cash or power to obtain it and can be converted into cash without incurring any loss. In its *ultimate analysis* a credit instrument brings *cash* which the commercial bank either promises to pay on demand or receives from its customers. Hence arises the direct relation between credit and currency. They are eternally linked together.

The amount of credit to be extended in a country at a particular time depends not merely on the demand for it, but substantially on the amount of currency on hand with the banks. If the

supply of currency with the commercial banks were not sufficient to meet the legitimate demand for it from producers, businessmen and others, credit may have to be curtailed by making it dear, and this would result in *deflationary* effects. On the contrary, if there is an excess of currency with the commercial banks over what is required by producers, businessmen and others, credit may be liberalized by being made cheaper, thus leading to *inflationary* effects. A *centralized control* over both the currency and credit is therefore an absolute necessity, if the country's economy is not to be harmed by inadequate adjustment of the amount of currency and credit to the requirements of production, business and trade. That institution, which ultimately supplies credit and controls it, must be the institution, which should supply currency and control it. In this relationship lies the true foundation of all monetary policy which is to bring about an equilibrium between supply of and demand for money at a given time in a country. Such an equilibrium will tend to bring about stability of prices and the consequent stability in business, production and employment.

Scientifically, monetary management is a Central Banking function. Being in intimate contact with the money market a Central Bank is in a singularly fortunate position to know *constantly, accurately* and *quickly* the *day-to-day demand* for money on the part of the money market. Who else can do so ? The mother-Bank's shadow spreads over the whole money market. It is in a position, therefore, to know best *when* and to *what* extent to expand or to contract currency and credit to meet the changing requirements of the money market. That institution which is enabled to gauge constantly and accurately the demand for money in the money market must also be the institution which should act as a *reservoir* of money. Demand for and supply of money, so to say, must meet in the same institution. This happy union is a necessity. Logically then, the monetary authority shall be a Reserve Bank, for it alone can bring the supply of money in equilibrium with the country's demand for it.

(B) CENTRALIZATION OF RESERVES AS TRUE BASIS FOR MONETARY POLICY :—In order, therefore, to establish a successful monetary policy, it follows as a natural consequence that the Central Bank shall be the *sole custodian* of (i) the cash reserves of commercial banks and of (ii) the currency reserves of

a country. Without this custody the Central Bank is powerless to have full control over the supply of money. The expansion or contraction of credit by commercial banks are governed by the *size of their cash reserves*, and unless a substantial part of these are kept as reserves with the Central Bank, it is impossible for the latter to establish its monetary policy effectively. It is indeed through the effect of the Central Bank action on the quantity of bank cash that monetary policy works.

Whenever a Central Bank is established either (i) law *compels* the various commercial banks to place a *minimum* of reserves with it, as in the United States and India, or (ii) commercial banks place certain parts of their reserve with the Central Bank of their own free will, governed by tradition or experience as in England and in some countries of Europe. This is *discretionary* reserve. The result is obvious. The scattered reserves of the commercial banks are removed from their vaults and become *centralized* in the vaults of the Central Bank. This centralization is of immense economic value. When reserves of commercial banks are pooled in substantial amounts with a single institution, they could be utilized *to the fullest possible extent* during periods of seasonal strain and in serious emergencies in the interests both of the banks as well as business. If a commercial bank is in danger of a run on it, the combined Reserve could be moved at a moment's notice by the Central Bank easily, quickly and in full force to meet the bank's immediate needs, In this respect the Central Bank occupies the position of an *insurance company* to which the various commercial banks subscribe their funds to meet emergencies. Each individual commercial bank does not take the entire risk of meeting emergencies on itself, but gets it distributed among all its colleagues. Even if the panic is general and larger demands are made on commercial banks, the *mobilization* of the reserves in a single mass makes adequate payments possible without any fear of exhaustion. But a still greater advantage lies in the fact that, as the reserves are pooled with the Central Bank, on their combined strength the Central Bank can intervene vigorously in the country's business by *extending credit facilities liberally*. In the words of Dr. De Kock, in his *Central Banking* (p. 70) : "The centralised cash reserves can form the basis of a much larger and more elastic structure than the same amount scattered among the commercial banks."

The combined Reserve in accumulation forms an excellent basis for larger credit. The centralization of reserves affords another advantage. It gives *mobility* to the reserves. Money can be moved from a place where it is redundant to another where it is scarce, so that the surplus of one place can be sent to meet the deficiency of another. Scattered reserves cannot be applied with full strength for this purpose, for they must first be gathered together before they are so applied.

Centralization of Reserves under the protective hand of a Central Bank has enabled commercial banks to keep *much smaller reserves* with themselves without sacrificing liquidity or security, than they would have in the absence of a Central Bank. In periods of seasonal stringency or emergency they have the Central Bank to fall back upon for financial help, so that normally they need not keep relatively large reserves. This reduction in reserves brings a two-fold advantage to the commercial banks : (1) it saves them from locking up large amounts which they could now utilise profitably in the form of loans or investments, and (2) they could extend greater credit than before. It, therefore, benefits not merely the commercial banks but business also, by making the monetary system more *elastic*.

Mobilizing the commercial banks' reserves in a Central Bank, which is ever ready to come to their rescue in times of need, must create the feeling of safety and confidence in the hearts of the clients of these commercial banks. This would therefore be an inducement to depositors to increase their investments, particularly in the form of time deposits with them. An increase in the amounts of time deposits is a sign of healthy growth. It normally postulates confidence on the part of the public in the commercial banks and at the same time makes available a larger source of capital which they can advance to businessmen. Money which would otherwise be idle and therefore useless, is pooled together for active use in the interest of the money market.

It is this centralization of reserves that also enables the Central Bank to keep a watchful eye and a direct control over the working of the commercial banks. The inflow or outflow of the amounts of the reserve of a commercial bank in the Central Bank's vaults, must act as a barometer indicating the actual condition of credit transactions undertaken by such a bank. It acts as a constant guide to the Central Bank which, presumably by statute,

is invested with the powers to supervise and keep control over the working of the commercial banks.

(C) CASH RESERVES OF SCHEDULED BANKS WITH THE RESERVE BANK OF INDIA :—In conclusion, the main functions of *minimum reserve requirements,* whether imposed by law or by custom upon commercial banks, are (i) primarily to ensure safety and liquidity of these banks themselves ; (ii) to enable the Central Bank to use effective control over the credit transactions of the commercial banks, *i.e.* to enforce its credit policy ; and (iii) to provide the Central Bank with adequate resources to manage the monetary system of the country.

To guarantee successful performance of these functions, the statutory (or customary) minimum reserve requirements, *i.e.* the *ratio of cash to deposits* which the commercial banks hold as liabilities and which they *should place as minimum cash reserve* with the *Central Bank* from day to day, should be *sufficiently high.* For it would ensure safety to the depositors and enable the Central Bank to possess sufficient resources wherewith to guarantee to a great extent the solvency of the commercial banks, as well as to keep effective control over credit and management of the monetary system.

The Reserve Bank of India Act places *legal obligation* on commercial banks to maintain *minimum reserves* with the Reserve Bank. In this respect it follows the Federal Reserve Act of the United States. It provides that every commercial bank, called a '*Scheduled*' bank (because it is included in the schedule of commercial banks which have joined the Reserve Bank link), shall maintain with the Reserve Bank a *balance* the amount of which *shall not* at the close of business on *any one day be less* than *five per cent.* of the *demand liabilities* and *two per cent.* of the *time liabilities* of such bank in India.

The following Table A shows the balances maintained by the Scheduled banks with the Reserve Bank of India.

TABLE A

Scheduled Banks' Deposits and Reserves with the Reserve Bank of India

In Lakhs of Rupees

AVERAGE OF FRIDAYS	Number of Scheduled Banks (a)	LIABILITIES IN INDIA			CASH	Balance with Reserve Bank (f)	Excess of (e) over Statutory Minimum (g)	(e & f) as percentage of (d) (h)
		Demand (b)	Time (c)	Total of (b & c) (d)	(e)			
1938-39	55	129,98	107,85	237,83	6,64	15,94	7,28	9.50
1944-45	84	584,85	194,12	778,92	27,31	89,25	56,90	14.96
1945-46	91	654,53	259,52	914,05	34,80	89,91	51,99	13.64

The Table A shows that in 1945-46 the Demand deposits were Rs. 654,53 lakhs and the time deposits were Rs. 259,52 lakhs. Calculating 5 per cent. of the former and 2 per cent. of the latter, according to the *legal* requirements, the total balances with the Reserve Bank should be nearly Rs. 37,92 lakhs. But the actual balances shown are Rs. 89,91 lakhs. This excess of Rs. 51,99 lakhs is the *discretionary* reserve on the part of the banks which they have kept with the Reserve Bank.

Since most of these *excess* reserves are the result of inflation prevailing during the war, no full trust could be placed on their continuance in normal times. But this apart, the *legal minimum cash ratios are too small to be effective.* The framers of the Act were probably influenced by the verdict of the Committee on Bank Reserves of the Federal Reserve System in 1931. The Committee stated that "it is no longer the primary function of legal reserve requirements to assure or preserve the liquidity of the individual member bank." But this judgment was given at a period when the Federal Reserve System had made great advances and was working in an almost perfectly well-developed bill market in which the re-discount function was giving sufficient liquidity to the member banks. The case of India is entirely different. Within four years of the passing of the Act the Reserve Bank was plunged into the troublesome arena of war finance. In addition, there is no bill market in India.

But in the United States when a steady inflow of refugee funds was taking place from 1933 onwards and the excess reserves were mounting up, an event of outstanding importance for the development of banking and monetary conditions took place. It was the passage of the Banking Act of 1935. This law authorized the Board of Governors of the Federal Reserve System to *change* the legal cash reserve ratios which member banks must maintain in the form of balances with the Federal Reserve Banks provided that " the reserve requirements are not reduced below present requirements or increased to more than *twice* present requirements."* The Reserve requirements could therefore be raised by any amount upto 100 per cent. But the purpose stated therein was " *in order to prevent injurious credit expansion or contraction.*"† In accordance with this Act, the reserve requirements were raised in three stages, in July 1936 and March and May 1937 to the legal limit. By this means the requirements were doubled.‡ It is officially stated that " this action was taken for the purpose of removing from the credit base a large volume of unnecessary reserves arising entirely from the inflow of gold from abroad and constituting the basis of a possible injurious credit expansion."§ And the result was that " through the elimination of about $3,000,000,000 of excess reserves, the Federal Reserve System was brought into closer contact with the market and was placed in a position where sales or purchases in the open market could tighten or ease credit conditions in accordance with the public interest."¶

If Indian banking organization were to work safely, smoothly and to develop along sound lines, two provisions are necessary.

In the first place, the legal cash reserve ratios which the Scheduled banks must maintain with the Reserve Bank of India and which are too low and feeble at present, must be *permanently raised*—sufficiently high to empower the Reserve Bank to institute adequate control over the credit transactions of these banks and ensure their liquidity in normal times. In the second place, the Reserve Bank must be given *the power to make changes in legal cash reserve ratios* in the interest of the money market.

* League of Nations: *Monetary Review*, 1936, page 37.
† " " " *World Economic Survey*, 1936-37, page 183.
‡ " " " *Commercial Banks*, 1936, page 168.
§ *Federal Reserve Bulletin*, May 1937, page 377.
¶ *World Economic Survey*, 1936-37, page 183.

The possession of this power would considerably strengthen the power of the Reserve Bank in preventing injurious credit expansion or contraction on the part of the Scheduled banks in times of boom or depression. The Reserve Bank's power to make changes in the legal cash reserve ratios will act as a great restrictive force. It will hang over the Scheduled banks as a constant threat, so that they would ever be restrained for expanding or contracting unwanted cash. If the monetary system is to work in harmony and in the interest of the money market, these statutory powers must be bestowed on the Reserve Bank of India.

CHAPTER II

The Bank of Issue

Every Central Bank in the world has been entrusted by Legislation with the monopoly of note issue. A similar right was given to the Reserve Bank of India by the Reserve Bank of India Act, 1934, and as a result the monopoly of the Government of India for issuing notes ceased to exist. This was a happy change.

(A) GOVERNMENT *VERSUS* BANK NOTE ISSUE :—In practice a Government cannot possess an accurate knowledge of the demand for notes by the business and trade of the country from day to day, because, not being engaged in banking, it cannot come into direct contact with them. Government can know their changing demand only through the banks of the country. Consequently, a government will fail to adjust the supply of notes to meet the demand for them adequately. This inability is bound to be acute in an emergency, for Government is a slow but cautious mechanism and is not readily responsive to sudden changes.

But the case of Central Bank issue is different. A Bank note fulfils the principal object of keeping the volume of notes constantly adjusted to the requirements of business and trade, because its issue is *directly based on business transactions*. If banking business is legitimate, the issue of Bank notes is the *result of extending credit*. If credit is judiciously extended, Bank notes will go into circulation through the commercial banks when business demands them, and return to these banks when the need is over. Mr. De Kock states that " the weekly statements of all Central Banks bear adequate testimony of the fluctuations of the note circulation depending upon what week of the month, or what month of the year or what stage of the business cycle it is."*

If, for instance, business is prospering, many bills will be brought to the commercial banks by businessmen for discount and the number of notes issued will be large. But if the business

* *Central Banking*, page 35.

demand is still growing, the commercial banks will *rediscount* most of these bills with the Central Bank and obtain more Bank notes. On maturity of the bills, however, the Bank notes will return to the Central Bank. The issue of Bank notes therefore becomes *automatic* and *elastic*. On the contrary, in times of dull trade a smaller number of bills will be presented at the commercial banks and fewer Bank notes will be issued and there will be fewer bills brought to the Central Bank for rediscount.*

The real danger involved in the issue of notes by a Government lies in the fact that "political considerations and the pecuniary needs of the State rather than considerations of a sound monetary economy is likely sooner or later to become the determining factor. There will be a risk of excessive issues and consequent depreciation."† Exigencies of party politics, budget deficits and various other evils have led many Governments to trespass on the legitimate bounds of note issue. There was in the past, for instance, nothing to prevent certain Governments from having resort to the printing press to issue notes on the fictitious backing of 'created securities'. The intrinsic weakness lies in the fact that a Government is the ultimate controller of money and there is no other body directly above it to keep in check its manipulations.‡ But this danger does not exist in a Central Bank note issue. Its issue is based on business principles. The amount of its issue is regulated by specific laws and by the real need of the business community. At the same time, needy Governments have compelled Central Banks to be their tools in providing them with the needed finance; but as Mr. De Kock expresses "the resistance which may be offered by a Central Bank against unsound currency designs on the part of the State is at least one advantage in favour of a Central Bank being the issuer of notes."§ But would a Central Bank dare to raise its voice against the coercive force of a needy Government?¶

* "The issue of bank notes at the principal banks of the world still takes place technically in accordance with the necessity of the commercial public composing their clientele." Parker Willis: *The Theory and Practice of Central Banking*, page 265 (1936).

† Kisch and Elkin: *Central Banks*, page 72.

‡ Author's: *A Reserve Bank for India and the Money Market*, page 20.

§ *Central Banking*, page 34.

¶ "But it is obvious in the case of nearly every institution that Government necessities and political issues have compelled a wide variation from the strict canons of note issue based upon actual exchange requirements that had been regarded in one form or another as absolutely controlling up to the present time." Parker Willis: *The Theory and Practice of Central Banking*, page 265.

(B) MONOPOLY OF NOTE ISSUE TO A SINGLE BANK: A monopoly right of note issue given to a Central Bank is an economic necessity. As stated in this chapter when a Central Bank is given the function of controlling credit solely in a country, it follows as a natural consequence that it should have the sole monopoly of the supply of paper currency. The credit structure which the Central Bank can build up will depend upon its control over the supply of currency, and if this control is split up among many issuing banks it would be impossible to mobilize currency. In time of stress, in particular, this centralized control over note issue is of immeasurable value to the Central Bank in rendering help to the money market. Besides, with multiplicity of notes, there would be multiplicity of reserves, which in times of emergency would be impossible to mobilize.

Great danger lurks in the system of multiple note issues. Since banks compete with one another for business to earn increasing profits and since issuing notes is a profitable business, there is nothing to prevent them from trespassing the legal limits of issue. Another result will be that in trying to outdo one another in trade, the competing banks would be drawn in to reduce the reserves below the limits of safety. If then a run occurs on a particular issuing bank which finds itself unable to meet the demand for redemption, it will lead to a panic which will spread the contagion to the other issuing banks, and "distrust spreads the demand to other banks in a similar condition and the system, honeycombed by competition, falls into ruins."* With a multitude of banks there would be divided responsibility and divided management, and it would be difficult for either the Government or the public to exercise control over them. But the very independence of a bank with monopoly privileges, writes Mr. E. D. Jones, "removes from it all temptation such as might be presented in competition with rivals to extend its issues beyond the limit of safety. As the struggle to earn dividends is absent the bank may order its policy to secure public welfare."†

With a single issuing Bank it is easy to locate responsibility in one centre. Further, a single note issue commands that prestige which has great influence on the psychology of business-men during times of emergency. It tends to create confidence

* E. D. Jones: *Economic Crises*, page 112.

† *Ibid.* page 111.

in the management of the Central Bank during times of panic.

(C) THE CANONS OF BANK NOTE ISSUE :—The test of the usefulness of a Central Bank note issue system lies in its observance of certain canons : (i) Essentially, it should provide *perfect security* to the note issue, *i.e.* the convertibility of the notes into specie shall be secured at any moment on demand. Then only the public will have the fullest confidence in the notes.

(ii) It is important to have *elasticity* in the note circulation. It means "responsiveness to present increase or diminution of demand—the power of adaptation to the needs of the month, the week, or the day, whether rising or falling."* It should have the power to expand and contract as the volume of business expands and contracts. It should quickly respond to the varying needs of business.

(iii) The note issue should also be managed in the *interest of the money market.* The Central Bank should be ever ready to *purchase* bills, promissory notes and other *eligible paper* drawn by businessmen, in order to extend financial assistance to them in business. This will make the note issue not only elastic but also *automatic.* The volume of currency should be thoroughly adjusted to the volume of credit in the country.

(iv) The Central Bank should guard against unwanted expansion or overissue on the one hand, and against unwanted contraction or stringency on the other. This will tend to bring stability in interest rates and stability in prices, and help the money market to undertake transactions smoothly.

Law ought therefore to provide that the Reserve or Assets that have to be kept as a *backing* or *cover* for note issue should consist of : (i) bullion and coins to fulfil the requirement of the first canon ; (ii) investments in approved Government securities which could be sold off in an emergency readily and without loss and cash obtained ; and at the same time these investments bring interest, whereas if the Reserve were to be in bullion only, it would be wastefully locked up ; (iii) bills of exchange and other eligible paper on its portfolio. Provisions (ii) and (iii) would tend to satisfy the other canons.

(D) THE PRINCIPAL SYSTEMS OF NOTE ISSUE :— Different regulations have been laid down by various countries

* Dunbar: *Economic Essays*, page 288.

in regard to the regulation of note issue. The chart given below classifies simply the principal ones.

Regulation of the Note Issue

- **(a) Regulating the Reserve**
  - **(i) Fixed Fiduciary System, *e.g.* England & India (before 1935)**
  - **(ii) Proportional Reserve System, *e.g.* the U.S.A.**
- **(b) Fixing a *maximum limit* to the amount of the notes, *e.g.* France upto 1928.**

(i) FIXED FIDUCIARY SYSTEM.

Literally, 'Fixed Fiduciary' means the *invested* portion is fixed in amount by Law. An example will make explanation of this System clear. Suppose Rs. 300 crores of notes are in circulation and that by Law Rs. 40 crores ought to be kept in the Reserve in *investments* in Government securities as a fixed part. Then Rs. 260 crores *must* be kept in bullion or coins in the Reserve as cover for the notes. Now suppose Rs. 1 crore more of notes are needed in circulation by business. Then Law compels the monetary authority to *first* place in the Reserve Rs. 1 crore in *bullion* (or coins) and then issue the additional notes. Therefore, this system requires that all notes issued *over and above* the fixed fiduciary limit ought to be covered 100 per cent. by bullion.

The Fixed Fiduciary System is typically adopted by England under its Bank Charter Act of 1844. Its *essential* features may be stated :—

(*a*) The Bank of England is authorized to issue its own notes *on the security of Government debt* to an amount fixed by statute, *i.e.* £14,000,000 (this is the fixed fiduciary limit).

(*b*) But any additional notes *over and above* this fixed fiduciary limit have to be secured by a gold backing of 100 per cent.

(*c*) If more currency is needed, as for instance in a crisis, nothing remains but to suspend the Bank Act, and thus give the Bank the privilege to issue notes *unsecured by gold* (*i.e.* the fiduciary limit is extended).

(d) Further, if the fiduciary issue has to be raised at the time of an emergency an extraordinary and inconvenient procedure has to be followed calling the Parliament to sanction the suspension of the Bank Act.

However, an element of elasticity was introduced in this system by the Currency and Bank Notes Act, 1928 which introduced two features :—

(i) It authorized the Bank to increase the fiduciary limit, *i.e.* to issue notes against Government securities to an amount of £260,000,000.

(ii) It empowered the Bank to increase this fiduciary limit by the sanction of the *Treasury* immediately communicated to Parliament. This could only be for a period of six months ; and it may be renewed for the next six months, provided that no fiduciary circulation can exist for more than two years without the express sanction of the Parliament. Thus a simpler and more certain method was introduced instead of the old crude method of suspending the Bank Act. As a consequence of this Act more than four times the fiduciary issue was raised.

AN ESTIMATE OF THE SYSTEM :—The greatest defect of the Fixed Fiduciary System is its rigidity or *inelasticity*. Expansion and contraction of note issue beyond the fixed fiduciary limit takes place at a rate *exactly equal* to the increase or decrease of the gold reserve. The system is therefore thoroughly unsuited to a country whose business and trade are expanding. Similarly, it fails to adapt itself quickly and to the full extent in time of an emergency when there is heavy demand for currency. On the other hand, it brings almost complete security to the note issue, and is a check on unwanted expansion of credit and currency in good times. Unless, the Central Bank first purchases gold and deposits it in the Reserve, additional notes could not be issued by it and this itself places a restraint on credit expansion. The money market itself is conscious of this limitation.

(ii) PROPORTIONAL RESERVE SYSTEM :—' Proportional Reserve ' postulates that the *metallic* portion of the Reserve is by law a certain *minimum percentage* or ratio of the *total notes issued*. Suppose the ratio fixed is 40 of metal to 100 notes issued. It means for *every* 100 units of notes issued the monetary authority need keep only 40 units of metal. But the remaining 60 units of notes are not left *uncovered*. They are fully secured

by investments in (i) Government securities or/and (ii) eligible commercial paper. If then 200 units of notes are to be issued, the metallic portion of the Reserve will be 80 units and collateral 120 units, and so on for larger issues of notes.

The Proportional Reserve System in its most highly developed form is operating in the United States of America.* The essential features embodied therein are as follows :—

(1) Under it, notes in active circulation are secured by a *minimum percentage of gold and gold securities*, which is 40 per cent.

(2) The minimum percentage is not rigidly fixed, but may be transgressed with the consent of the Government for *short periods* on the condition that the issuing Bank pays the tax reckoned on the amount of the deficiency. The tax is made to rise steeply as the deficiency increases.

(3) As regards the remaining 60 per cent. of the note issue, they are to be secured completely by certain forms of '*collateral.*' These have been Bankers' Acceptances and other rediscountable paper and Government securities.

(4) The reserve to be held against *deposit* liabilities is fixed at 35 per cent. gold and lawful money.

AN ESTIMATE OF THE SYSTEM :—The characteristic virtue of the Proportional Reserve System is that expansion and contraction of note issue do not take place at the same rate as the gold reserve is increased, or decreased, but that it permits expansion, and forces contraction to take place in the proportion of 100 note issue : 40 gold and gold securities. Thus, an addition of 40 units to the gold reserve permits the Federal Reserve Banks to issue notes to the amount of 100 units ; conversely, a loss of reserve of 40 units forces a contraction of notes to the extent of 100 units. *Elasticity* then is the essence of this System.

But this System is not suited to a country like England which, before the Gold Standard was shaken off on 21st September 1931, had maintained an absolutely free gold market and was consequently the international banking centre of the world. London held enormous sums of foreign balances and was ready to discount foreign gold bills for gold. So that any moment there was the danger of a drain of gold to foreign countries. "The danger

* It was first adopted by Germany in 1875. The United States adopted the German principle in 1914. But Germany profited by the modifications made in the System by the United States and incorporated the new changes. This system has been adopted by most other countries.

of this percentage system," said Mr. A. C. Davidson, "lies in the cumulative effect of the withdrawal of gold."*

Under the circumstances, suppose the ratio of gold to notes were to be fixed at 33⅓ : 100 and that it was actually operative. If an unusual withdrawal for gold for export took place suddenly, and thereby reduced the proportion below the legal limit, it would force the Bank to withdraw notes in the ratio of 3 : 1. This would have the effect of causing violent contraction of notes and therefore cause enormous disturbances in the money market. It would also have the effect of pulling down the general level of prices and the consequent evils resulting from deflation. Such a danger then constantly exists in this system as applied to a country which is exceptionally subject to very large gold drains. This is the reason why England had for generations to cling to the Fixed Fiduciary System.

On the contrary, does this elasticity of note issue say, 100 : 40 give scope wide enough for inflation ? It does not do so, for expansion of note issue above a limit is checked by the imposition of a steeply rising tax which is punitive in its effect and which forces the Bank to take prompt measures to redress the situation. Mr. De Kock states the effect of the tax in the German system : "In other words, by taking away the profit incentive it helped to ensure the expansion of currency beyond the inner limit taking place only in emergencies and in peak periods of time."† Besides, the minimum limit could be lowered only for *very short periods* specified by the Act. Finally, as stated previously, securing the note issue by certain forms of collateral, *i.e.* admitting eligible commercial paper for re-discount, is one of the important methods that, on the one hand, enables the Federal Banks to extend a helping hand to the money market, but on the other hand it institutes a mechanism of automatic expansion and contraction of note issue which brings safety and liquidity to the Banks.

The percentage varies widely with different countries and depends on their special circumstances. But the fact remains that most countries have adopted the Proportional Reserve System of note issue.

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* *Central Reserve Banking:* A paper read before the Perth (W. A.) Branch of the Economic Society of Australia and New Zealand on 28th June 1928.

† *Central Banking*, page 29.

(B) LEGAL MAXIMUM LIMIT TO AMOUNT OF NOTE ISSUE :—This System of fixing by law the ***maximum*** amount of notes that could be issued by the Central Bank was working in France before 1928. The basis of this issue was that so long as the maximum limit of note issue was carefully determined and was fixed accordingly, no other safeguard on note issue was necessary. But with the changing demands of business for finance the maximum limit to note issue cannot remain constant. Besides, it is too *inelastic* and incapable of being adequately adjusted to changing requirements of the money market. In fixing the maximum it pays no regard to the intimate connection that constantly exists between note issue and the requirements of business. Further, before the actual maximum is raised by the Legislature, there is bound to be some period of inconvenience when business is kept starving of the funds required in the emergency. There is also an element of uncertainty involved in this issue, for there is no guarantee that this System may not prove a convenient handle in the hands of a Legislature in order to introduce unwanted inflation. France, therefore, after bitter experience threw out this system and adopted the Proportional Reserve System.

In Australia, the Commonwealth Bank of Australia (State-owned Bank) has been working the Proportional Reserve System. But, curiously, the Royal Commission, appointed in 1936 to inquire into the Monetary and Banking Systems prevailing in Australia, recommended in 1937 that " the note issue should be limited by law to a fixed maximum (for example, £60 m) subject to the right of the Bank to exceed the maximum by a stated amount (for example, £10 m) with the consent of the Treasurer." They seemed to have recommended this system because they found that the provision of even the low metallic reserve ratio of 25 metal : 100 notes was too rigid for the progressive export trade of Australia. Further, they stated, that the reserve ratio was of little use, " for if the Bank wishes to increase the volume of note issue, it can, by raising the exchange rate, increase the value in Australian currency of the note issue reserve, whilst keeping within the legal limits. On the other hand, the reserve limitation may cause embarrassment to the Bank if circumstances arise in which it wishes to reduce the exchange rate."*

* The Report of 1937, pages 224 and 225.

CHAPTER III

The New Note Issue System of India

1. INDIA'S NEED FOR ELASTIC NOTE ISSUE :—In taking any decision regarding the System of Note issue that ought to suit India best, the first consideration will have to be given to the *normal seasonal stringency*. In India, a predominantly agricultural country, there is the serious problem of financing the harvesting and movement of crops. During two periods of the year, when the Kharif (monsoon crops) and the Rabi (winter crops) are harvested and are to be moved from the villages to towns and cities, the volume of cash required is at its maximum. We need two vast *streams* of finance in order to finance the two streams of trade. But there is the slack season covering nearly three months of the monsoon, during which, the demand for cash is at its minimum. "The monsoon," said the late Sir Basil Blackett, once Finance Member, "thus increases the wideness of the margin between the amount of currency and credit required when activity is at its minimum during the year." In laying stress on the inevitability of monetary stringency, he also said, "stringency in the money market has its roots in the facts of nature."* The extraordinary variations in the demand for money during the year must necessarily lead to abnormal fluctuations in money rates and thereby harm business and trade. India is a country of vast distances with nearly seven lakhs of villages, studded over the country, and currency has to cover vast areas. Transport and communications are still extremely inadequate and as a consequence mobility of currency is very difficult. The farmer class constitute nearly 93 per cent. of the population. India's towns and cities hold but a tiny fraction of her enormous population. The average income of the farmer is very low. Education among this class is almost absent—nearly 92 per cent. of the population is completely illiterate. The farmer's greatest concern in life is the rainfall or its auxiliary,

* In his speech, while performing the opening ceremony on July 24, 1924, of the Branch of the Central Bank of India, Ltd., at Calcutta.

irrigation supply ; if either is normal he gets buried in his village politics. Mr. Finlay Shirras wrote : "The perpetual see-saw of good and bad years, due to the vagaries of the monsoon, which is the jugular vein of Indian trade, does not increase the cultivator's trust in things." And this is a main factor that imbibes the hoarding habit in the farmer. Besides, the almost total absence of facilities for pooling savings of the farmers adds to the difficulties. If mobility is almost impossible due mainly to want of communications, the farmer finds no chance to go out for work to supplement his farming income. This want of contact with the outside world makes him extremely conservative, suspicious and superstitious. All these factors conspire to make his *standard* of living miserably low. If a market is easily approachable, the farmer could be induced to purchase some things, even within the sphere of his very low standard ; that is to say, the currency which he has received in exchange for his crops could again be exchanged with commodities. But want of communications makes this very difficult. Consequently, the currency that goes to the village gets buried there for many months instead of returning to circulation quickly. These factors are responsible for keeping the velocity of circulation of currency to its lowest level. In short, we have to face the great problem of *enormous absorption of currency*. Rapid development of roads and of transport facilities in India will help to reduce to a considerable extent this absorption and will be of the greatest value to monetary circulation in the country.

In the United States of America and most countries of Europe deposit banking is so well developed that the cheque system plays a far greater role in financing business than currency. Far from being a mere auxiliary to the currency system, the cheque system is the currency in these countries. But to think of the cheque system existing in village India even after a hundred years to come would be nothing short of Arabian Night's Dream. In towns and cities the development of the cheque system has been in progress, particularly during the last decade, during which commercial banks have been spreading out their branches, but it is not commensurate with the elasticity needed by the country's business.

Under all these circumstances India needs an elastic system of Note issue.

2. THE NEW NOTE ISSUE SYSTEM :—With the inauguration on the 1st April 1935 of the Reserve Bank of India, the Issue Department of the Bank took over the management of the currency from the Government of India. The Issue Department from this date was made responsible for the maintenance and regulation of currency and for the investment of the currency reserves.

The Reserve Bank of India Act, 1934, has established the Proportional Reserve System of note issue and has followed as its basis certain important features of the Federal Reserve Act of the United States of America.

ISSUE DEPARTMENT OF THE RESERVE BANK OF INDIA

Total Assets (Reserve)

40%
in *gold coin, gold bullion* or *Sterling Securities.*
But *minimum* gold coin and bullion to be not less than Rs. 40 crores in value.

The remainder
60%
of the Assets.

(a) *Rupee coin and Government of India Rupee Securities.*
But the amount of the Securities shall not exceed 25% of total Assets or Rs. 50 crores.

(b) *Internal Bills of Exchange* and *Promissory Notes eligible* for purchase.

The above chart explains that (i) the proportional metallic reserve is 40 per cent. of the notes in circulation, but this part also includes *Sterling Securities*. However, Law provides that the amount of gold coin and gold bullion shall *not* at any time *be less* than *forty crores* of rupees in value. (ii) The remainder of the Assets shall be held in *rupee coin, Government of India Rupee Securities* of any maturity *and* such *bills of exchange* and *promissory notes* payable in British India as are eligible for purchase by the Bank under the Law. But a *maximum* limit is placed on the amount to be held in Government of India *Securities* which shall not at any time exceed *one-*

fourth of the total amount of the assets or fifty crores of rupees, whichever amount is greater, or, with the previous sanction of the Governor-General in Council, such amount plus a sum of ten crores of rupees.

It may be noted that no *maximum limit* is placed on the *total amount* of *rupee coin plus* Government of India Rupee Securities taken together ; so that there is nothing to prevent the Bank from keeping the whole of the remainder of the Assets, *i.e.* 60 per cent. in these items, disregarding thereby the essential constituent, eligible bills and promissory notes, whose ready purchase by the Reserve Bank of India is so necessary for helping the money market in an emergency. On the contrary, there is nothing in the Act to prevent the Reserve Bank of India from purchasing eligible bills and promissory notes upto an amount which would take up an undesirable percentage of the 'remainder of the Assets' at the expense of the other constituents, *i.e.* rupee coin and Government of India Securities. For example, there is nothing in the Act to prevent the Reserve Bank of India from purchasing bills, say, upto 50 per cent. of the value of the Total Assets, leaving 40 per cent. in gold and Sterling Securities and 10 per cent. in Rupee coin and Rupee Securities. It may be stated that purchase of *eligible* bills and promissory notes, which are guaranteed by a Scheduled Bank which demands their endorsement by Law, is not a hazardous investment on the part of the Reserve Bank and that therefore no maximum limit need be placed on such purchases. Further, if the Reserve Bank considers at any time that business is running faster than necessary leading to increasing amount of bills drawn and discounted, it could correct the situation by raising its Bank rate of Discount. But the danger lies in the inducement given to the Reserve Bank of India to relax certain conditions of purchase at times when there is big demand for accommodation on the part of business.

Too much discretion and wide freedom are given to the management of the Reserve Bank. However, it is to be stated to the credit of the Act that *great elasticity* is introduced in the system of Note issue. Indeed, everything depends on the prudence and foresight with which the Note issue is managed.

(iii) Further, as in the Federal Reserve Act of the United States, there is provision in the Act for *suspension of asset*

requirements in case of an emergency. It provides that the minimum percentage (40 : 100) may be transgressed with the previous sanction of the Governor-General in Council for periods not *exceeding thirty days* in the first instance, which may with the like sanction, be extended from time to time by periods not *exceeding fifteen days*, hold as assets gold coin, gold bullion or Sterling Securities of *less aggregate* amount than 40 per cent. that is required, provided that the gold coin and bullion held as such assets shall not be reduced below forty crores of rupees, so long as any Sterling Securities remain held as such assets. But the Reserve Bank shall pay to the Governor-General in Council a *tax* upon the amount by which such holding is reduced below the minimum prescribed. This tax is graduated and is rising upwards.* The tax is made, as stated previously, punitive and after a stage is reached it is prohibitive, for issuing notes beyond a particular upper limit and paying a tax at the same time would inflict a positive loss on the Reserve Bank.

This clause makes provision for additional elasticity to Note issue, at the same time by the restrictions imposed along with the power to regulate the Bank rate considerable security is given to Note issue.

The Table B below shows the position of the Note Issue System in the hands of the Reserve Bank of India on *its inauguration*. It gives the Liabilities and Assets of the Issue Department as shown in that Department's first weekly statement dated the 5th April 1935.

* The Reserve Bank of India Act, Section 37 (2): "And such tax shall be payable at the Bank rate for the time being in force, with an addition of one per cent. per annum when such holding exceeds thirty-two and a half per cent. of the total amount of the assets and of a further one and a half per cent. per annum in respect of every further decrease of two and a half per cent. or part of such decrease.

Provided that the tax shall not in any event be payable at a rate less than six per cent. per annum."

It may be noted that the actual period of suspension and the scale of the tax (with slight modification) are taken from the Federal Reserve Act, Section II (c).

TABLE B

Account pursuant to the Reserve Bank of India Act 1934 for the week ending the 5th April 1935

Issue Department

(In thousands of Rupees)

Liabilities.		*Assets.*	
1. Notes held in the Banking Department ...	19,05,29	A. *Gold coin and Bullion*	
		(a) Held in India ...	41,55,19
		(b) Held outside India	2,86,98
		(c) Sterling Securities	48,62,95
2. Notes in circulation ...	1,66,99,97	*Total of A* ...	93,05,12
		B. (1) Rupee coin ...	49,94,95
		(2) Government of India Rupee Securities ...	43,05,19
		(3) Internal Bills of Exchange and other commercial paper	...
Total Liabilities ...	1,86,05,26	Total Assets ...	1,86,05,26

The main point of interest is concerning the gold coin and gold bullion assets which the Government of India handed over to the Reserve Bank of India. These gold assets symbolize the *amalgamation* of the two Reserves : (i) The Paper Currency Reserve, and (ii) the Gold Standard Reserve, which the Government of India used to hold before 1st April 1935 and which they handed over to the Bank on that day. The total of gold coin and bullion as shown in the above Table was Rs. 44.42 crores (valued at the statutory parity) and this was made up of the gold holdings of the Government of India (i) the value of Rs. 41.55 crores in the Paper Currency Reserve, and (ii) Rs. 2.87 crores in the Gold Standard Reserve. Similarly, the Sterling Securities belonging to the two Reserves were also handed over. It will be noted that when the Reserve Bank of India took over the assets, the gold coin and bullion combined with the Sterling Securities stood at Rs. 93.05 crores and together amounted to 50.01 per cent. of the total Liabilities, instead of 40 per cent. required by Law.

3. REMARKABLE CHANGES IN THE ISSUE DEPARTMENT IN SUBSEQUENT YEARS :—Since the commencement of the operations of the Reserve Bank of India the Note issue began to show a continuous rise ; but the increase became very noticeably rapid during the months following the outbreak of the World War II, and brought about a marked change in some of the constituents of the Assets. This will be seen in Table B1 on page 26.

The continuous increase in note circulation was the result of many factors.

(i) It was due to the increased tempo of industrial production and other business activities connected with the War. India's total expenditure, civil and military, during the five years (1939-40 to 1943-44) aggregated Rs. 1,005 crores. Taking the expenditure in 1938-39 as the basis, the total normal expenditure of these years would have been Rs. 426 crores. This extra expenditure of Rs. 579 crores should be the consequence of demands made for War supplies. To this expenditure is to be added during the same period the help which His Majesty's Government gave to India under the terms of the Financial Settlement concluded in September 1939. So that the total defence and supply expenditure reached the high figure of Rs. 1,641 crores.

Particularly since the time the Japanese invasion reached India's doors the country was rapidly transformed into a great United Nations arsenal for the Eastern and Middle East theatres of the War, and far greater demands were made on India's production, constructions, supplies and services.

(ii) Again, India has had to provide large supplies to the United States of America by way of *reverse Lend-Lease* in return for the Lend-Lease aid she was receiving from the latter. With regard to these reciprocal arrangements, the late President Roosevelt stated in his Report that, " We are not loaning money under Lend-Lease. We are not receiving payments on account under reverse Lend-Lease. The Lend-Lease system is, instead, a system of combined war supply, whose sole purpose is to make the *most effective use* against the enemy of the combined resources of the United Nations, regardless of the origin of the supplies or which of them uses them against the enemy. . . . Lend-Lease and reverse Lend-Lease are a system of combined war

supply. They should end with the War."* This reciprocal system saved time, transport and currency exchanges. More than 99½ per cent. of all supplies and services locally procured in India by the United States forces were provided as reverse Lend-Lease by the Governments of the United Kingdom and India.* The financial value of reverse Lend-Lease in India received by the United States throughout the four years ended July 1945 amounted to $516,713,000.† This represents the cost of the aid which India and the United Kingdom bore and for which no payment was made by the United States. But on the opposite side, India received by this date from the United States under Lend-Lease policy, for which India had not to make any payment, industrial materials and agricultural products worth nearly $2,033,385,000.‡

* Seventeenth Report to the Congress on Lend-Lease Operations, pages 7 and 33.

† Twentieth Report on Lend-Lease Operations to the Congress by President Truman.

‡ It is interesting to know the magnitude of the help given by the United States to all United Nations and the help she received in return from them under Lend-Lease and Reverse Lend-Lease arrangements. Upto July 1945 the United States of America had furnished $42,020,000,000 worth of Lend-Lease and received reverse Lend-Lease aid estimated at $ 5,600,006,000. These figures were given in the Report to Congress which was released by President Truman on August 29, 1945.

TABLE B 1

THE RESERVE BANK OF INDIA

ISSUE DEPARTMENT

(Lakhs of Rupees)

	Notes in Circulation	Notes in the Banking Department	*Total Notes Issued*	Gold coin and Bullion	*Sterling Securities*	Rupee coin	Rupee Securities	Bills, etc.	(4 + 5) as *percentage* of 3
	1	2	3	4	5	6	7	8	
Average of Fridays									
1935-36	164,11	27,54	191,65	44,42	62,13	55,52	29,58	Nil	55.60
1936-37	175,98	25,70	201,68	44,42	69,63	64,01	23,62	"	56.55
1937-38	186,14	25,64	211,78	44,42	79,90	60,24	27,22	"	58.70
1938-39	182,36	28,28	210,64	44,42	66,95	67,11	32,16	"	52.91
1939-40	209,22	18,79	228,01	44,42	78,63	67,52	37,44	"	53.97
1940-41	241,41	17,26	258,67	44,42	129,92	35,87	48,46	"	67.39
1941-42	307,68	12,21	319,89	44,42	165,00	35,28	75,19	"	65.47
1942-43	513,44	11,80	525,24	44,42	319,11	22,33	139,38	"	69.21
1943-44	777,17	10,50	787,67	44,42	643,52	14,28	85,45	"	87.34
1944-45	968,69	10,93	979,62	44,42	863,73	13,52	57,95	"	92.70
1945-46	1,162,64	16,14	1,179,05	44,42	1,061,26	15,53	57,84	"	93.78

ACCUMULATION OF STERLING BALANCES :—Particular mention must be made of the enormous purchases made in India by His Majesty's Government and various types of disbursements which India had to make on their behalf. *All these were paid for in Sterling in England against which Rupees were issued in India by the Reserve Bank of India for actual payments in this country.* The result was that notes increased in circulation in India against Sterling Securities in the Assets of the Reserve Bank of India in the Issue Department and also in the ' Balances held abroad ' in the Banking Department. The following Abstract in Table B2 explains the changed conditions at a glance.

TABLE B 2

(Lakhs of Rupees)

	TOTAL NOTES ISSUED	STERLING SECURITIES		
		In Issue Department (a)	In Banking Department (b)	*Total Sterling Balances* (a+b)
Average of Fridays				
1938-39	210,64	66,95	4,21	71,16
1945-46	1,179,05	1,061,26	488,23	1,549,49

The conclusions to be drawn are that

(i) the Note issue *increased* nearly 5½ *times* what it was in 1938-39,

(ii) *increase* in Sterling assets was nearly 22 *times* what it was in 1938-39.

Further, a reference to Table B1 on page 26 will show that : (*a*)* the gold coin and bullion Assets have remained the same in weight and their value is shown to be constant year after year. Its value, Rs. 44,42 lakhs, was originally fixed at 8.47512 grains of fine gold per Rupee. Although the price of gold has varied during the last three years between Rs. 90 and Rs. 95 per tola, the gold has not been revalued at the new prices ; (*b*) the backing of gold coin and bullion and Sterling Securities has increased from

40 per cent. to 98.63 per cent. of the total notes issued, but this increase is due overwhelmingly to the increase in Sterling Securities; (*c*) no eligible commercial paper has been taken on the portfolio of the Assets of the Issue Department. This part of the Assets has not functioned at all.

4. PURE GOLD BACKING OF 40 PER CENT. WILL BE NEEDED :—With the end of the War, deflationary process will have to be continuously undertaken in order to withdraw from circulation the enormous amount of notes for which there will be no use in circulation. The redundant notes will have to be withdrawn from circulation. It will be a difficult but steady and cautious process. On the other hand, with the contemplated economic development, both private and Governmental, going ahead and productive capacity increasing fast, the monetary demand from business for notes will increase in far greater proportion than what it used to be during the pre-war years. It may be assumed that a few years after the end of the War the Monetary Authority will have to provide for a Note issue of, say, nearly Rs. 400 crores, that is, nearly *double* the amount of note issue which existed in 1938-39. Under the circumstances, it would be prudent to prepare the ground for placing the Assets of the Issue Department on a more solid and secure basis. It is during the period of great business activity that credit expansion is likely to run amok, creating an ever-increasing demand for notes. Therefore, it is imperative to place a restraining force, and later a strong brake on unwanted monetary expansion. Let the Reserve Bank of India keep the ***metallic*** backing, ***i.e.*** the ***gold coin and gold bullion backing alone*** of 40 per cent. of the Note issue, (instead of the present 40 per cent. backing in gold coin and gold bullion and *Sterling Securities*). On this basis the total value of gold will have to be worth Rs. 160 crores. Assuming the price of gold to remain after a few years at Rs. 50 per tola, ***revaluation of the present stock of gold coin and gold bullion*** at this price would bring up the value to Rs. 105 crores. The remaining Rs. 55 crores would be devoted to the purchase of additional gold at the same price of Rs. 50 per tola and a part of the Sterling balances should be earmarked for this purpose. Thus :—

NOTE ISSUE	GOLD BACKING OF 40%	
In crores of Rupees	*In crores of Rupees*	
400	(i) Revaluation of present gold and gold coins (@ Rs. 50 per tola)	105
	(ii) *Purchase* of additional gold (@ Rs. 50 per tola) ...	55
	Rs. ...	160 crores.

There is nothing sacrosanct about the change being brought about only when the price of gold is at Rs. 50 per tola. The Monetary Authority would be the wisest judge in deciding at which stage of the price of gold, the revaluation and the purchase of gold should take place. But it should be made clear that if the price of gold falls below Rs. 50 per tola after the change is established and thereby reduces the total value of the gold below Rs. 160 crores, *i.e.* 40 per cent. of the Note issue, additional gold should be purchased of the value equal to the deficiency so caused. It should be a sliding scale process but working in the lower direction only.

5. SUMMARY OF CHANGES BROUGHT ABOUT :—The changes which the inauguration of the Reserve Bank of India has brought about in the country's currency system may be summarized in a comparative tabular form as follows :—

BEFORE 1935	SINCE THE ESTABLISHMENT OF THE RESERVE BANK OF INDIA
1. Government had the monopoly of Note issue. (Managed by the Controller of Currency)	1. The Reserve Bank of India is given the monopoly of Note issue. This Bank's Notes are guaranteed by the Government of India, but Government has ceased to issue Notes. (Managed by the Reserve Bank of India.)
2. There was Fixed Fiduciary system of Note issue. (Inflexible Note issue.)	2. The Proportional Reserve System of Note issue is established. (Elastic Note issue.)
3. Currency and Banking Reserves of the country were separate. (No coordination of currency and credit.)	3. The Reserve Bank of India has been the custodian of Currency and Banking Reserves. (Coordination of currency and credit introduced.)
4. There were two separate Currency Reserves :— (*a*) The paper Currency Reserve : (i) in London and (ii) in India. (*b*) The Gold Standard Reserve in London.	4. The two old Currency Reserves have been *amalgamated* into a single Asset of the Reserve Bank of India and kept in India.

CHAPTER IV

Rediscount Function

1. THE WORKING OF REDISCOUNT FUNCTION :— Another scientific method of expansion of monetary circulation is through the function of *Rediscount* entrusted to a Central Bank. The operation of Rediscount consists in the *substitution of Central Bank credit for commercial bank credit in time of emergency*. Since a Central Bank has the monopoly of Note issue and has the custody of cash reserves, it is in a position to undertake this function of Rediscount. An example will tend to make the working of this function clear. Suppose a commercial bank, which is doing genuinely good business, has already discounted bills of exchange of its customers and has thereby given away cash. The discounted bills are now on the portfolio of this bank. Suppose it happens later that, *before* the bills are matured (that is, before the precise date for receiving payment from the acceptors of the bills arrives), there is an unusual pressure from other businessmen for a genuine demand for cash, say, to finance agricultural produce which is awaiting export, but the bank finds it has exhausted its own resources in legitimate lending to business. The easiest method to obtain ready cash to meet the situation is to *re-sell* the bills which are now endorsed by it, *i.e. rediscount* them with the Central Bank which pays cash. By this operation *immediate expansion of cash* takes place, for the cash received by the commercial bank is in its turn given away by it to needy businessmen. The rediscounted bills are taken over by the Central Bank on its portfolio and they will, on maturity, bring back cash automatically within its vaults, as the debtors who are acceptors of the bills, pay for them on maturity. Consequently automatic *contraction of cash* takes place. Rediscount, then, is one of the chief devices by which *elasticity* of Bank Note issue is secured. First class bills are self-liquidating assets, for when bills are discounted by a bank cash flows *out*, but when they are paid for on maturity cash flows *in* automatically.

Mr. De Kock states that "the original idea behind rediscounting was that no sound and genuine business transaction should be restricted or abandoned just because of a shortage of bank cash, and that, as such transactions would or could ordinarily be represented by bills of exchange, it would be sufficient to confine rediscounting to bills having a maturity corresponding more or less with the time taken to complete the transaction."*

It will be seen that rediscounting bills by the Central Bank enables commercial banks, when real necessity arises to immediately *turn into cash* a maximum of their *assets*, that is, they get *quickly liquidated* in times of stress such as seasonal harvesting and movements of crops or holiday seasons or tax payments or monthly pay-rolls when there is very heavy demand for cash, and the resources of the banks tend to be overstrained. Besides, with a Central Bank to fall back on at such times the commercial banks need not keep relatively large cash reserves in their vaults to meet an emergency, so that they are enabled to undertake a larger volume of business with the same reserves.

At the same time this is a quick and an indirect method by which business receives financial help from the Central Bank. It is an axiom of banking finance that no eligible borrower should be refused accommodation. Rediscount is an excellent method by which this accommodation can be given to businessmen by commercial banks, and only when they have exhausted their resources, through the instrumentality of a Central Bank which is truly acting as "Lender of last resort". The significance of Rediscount operation of a Central Bank is well expressed by Dr. W. A. Shaw, who states, "So long as rediscounting operates merely as the passing of bills from one discounter to another, it only equalizes the distribution of discounted paper or of discounting funds. But when rediscounting takes the form of application to the Central Bank, say, the Bank of England, then the market's normal discounting funds are unlocked or 'unfrozen' by means of the outside capital (the Central Bank's Capital) which reinforces or replaces those normal funds.".†

It should be noted that ordinarily it is the commercial bank which takes the initiative in rediscounting bills and is thereby

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* *Central Banking*, page 105.

† *The Theory and Practice of Central Banking*, page 81.

the intermediary that places the reserve funds in the money market for investments leaving the Central Bank to follow its action. It is therefore an *indirect credit.*

The central reservoir of cash is tapped by the commercial banks only in times of thirsty demand from legitimate business which they are not able to meet, because they have reached the required limit of extending credit and any further extension would endanger their minimum cash ratios. The cash flows into the money market to satisfy it, but returns quickly to the reservoir after it is completely quenched.

To *summarize* : the economic advantages that accrue from the function of Rediscount are that :—

(i) commercial banks obtain immediate liquidity ;
(ii) it gives elasticity to the monetary system by expanding cash immediately and at the right time ;
(iii) it gives automaticity to the monetary system, as when the bills are rediscounted cash is expanded, and when they are matured, cash is contracted ;
(iv) it enables commercial banks to conduct a large volume of business with the same reserves ;
(v) the Central Bank is enabled to pump cash into the money market appreciably when it is urgently needed.

2. LIMITATIONS ON QUALITY OF BILLS :—It may be borne in mind that as a Central Bank is the custodian of the nation's reserves, is the monopolist of Note issue, and moreover is the sole source from which commercial banks borrow in times of pressure, its reserves should be as *safe* as possible and at the same time as *liquid* as possible. Limitations should therefore be placed by Law on the quality of bills which the Central Bank shall rediscount.

Law should specify (i) the purpose for which the bill is drawn, (ii) the maturity, and (iii) the quality of the parties to a given transaction for which a bill is drawn in order to make it eligible for rediscount. A bill to be genuine should be a *bona fide* debt for a business transaction.*

The maturity of the bill shall be for a short period if the Central Bank is not to endanger its own liquidity. And the last fundamental to be observed is the solvency of the parties

* "There is nothing that requires more sleepless vigilance on the part of a banker than to take care that the debts he buys are genuine and not fictitious ones." Macleod : *Theory and Practice of Banking*, Vol. II, pages 421 and 422.

to a transaction from which the bill has taken birth. Specific information should be obtained regarding the financial position of the parties to the bill.

In order to give a certain security to the bill (a Bankers' acceptance) in the United States, Law insists on the *endorsement of a member bank before such paper is offered to the Federal Reserve Bank for rediscount.* The member bank's endorsement on a bill is a guarantee of its soundness. The maturity of the acceptance is limited to 90 days sight and that for paper drawn for an agricultural purpose to six months sight (exclusive of days of grace).

In matter of Rediscount, the Reserve Bank of India Act follows closely the lines prescribed by the Federal Reserve Act in the United States. The Act (Chapter II, 17) gives authority to the Reserve Bank (*a*) for the purchase, sale and rediscount of bills of exchange and promissory notes, (i) drawn on and payable in *India*, and (ii) arising out of *bona fide* commercial or *trade* transactions bearing *two or more* good signatures, (iii) *one of which shall be that of a Scheduled bank*, and (iv) maturing within *ninety* days from the date of such purchase or rediscount, exclusive of days of grace.

(*b*) But if the paper is drawn or issued for the purpose of *financing seasonal agricultural* operations or the marketing of crops, then one of the signatures shall be that of either a Scheduled bank or a *Provincial Co-operative Bank* and the paper shall be maturing within *nine months*.

The provisions contained in (*a*) are extended to paper issued or drawn for the purpose of holding or trading in *securities* of the Government of India, or a Local Government, or such securities of States in India, as may be specified by the Governor-General in Council. It will be seen that the most important requirement for a paper to be eligible for rediscount is that one of the good signatures on it shall be that of a *Scheduled* bank (or of a Provincial Co-operative Bank in case of financing seasonal agricultural operations). This is done, as stated above, *to give the quality of security* to the paper. If a Scheduled bank endorses a bill it presumably gives it the hallmark of quality. The Central Bank shifts the responsibility of guaranteeing the quality of the bill on the commercial bank, although it is always scrutinized carefully by the former.

A bill endorsed by a commercial bank is technically called a '*bankable* bill', and by rediscounting such a bill the Central Bank pumps money at a moment's notice into circulation ***through the commercial bank.***

The following abstracted Table C illustrates the extent to which the Reserve Bank of India has made use of the function of rediscount to help the money market.

TABLE C

THE RESERVE BANK OF INDIA

Banking Department

	BILLS PURCHASED AND DISCOUNTED
Average of Fridays	(Lakhs of Rupees)
1938-39	1,53
1939-40	2,87
1944-45	1,46
1945-46	3,35

The figures testify to the fact that the Reserve Bank of India has so far been able to render *insignificant* help to the commercial banks, by way of rediscount. Even in the pre-war year 1938-39 the amount of Rs. 1,53 lakhs formed a mere drop in the ocean of amounts required by business during seasonal emergencies.

The factors responsible for this failing are not far to seek. In the first place, there is the general practice of the commercial banks to make advances to businessmen, particularly in the form of *overdrafts* or *cash credits,* which nullifies the importance of bill discounting.

TABLE C 1

SCHEDULED BANKS

	ADVANCES IN INDIA	BILLS DISCOUNTED IN INDIA
Average of Fridays	Lakhs of Rupees	Lakhs of Rupees
1936-37	95,11	4,70
1937-38	113,43	6,28
1938-39	115,85	4,86
1944-45	224,22	11,16
1945-46	285,07	16,05

It will be deduced from the above Table C1 that *bill discounting formed only* 5 *per cent. of the advances* or less, made by commercial banks during any year. In this fact lies the limitations of the Reserve Bank of India regarding its function of rediscount. If the Scheduled banks themselves receive an infinitesimal amount of bills for discount, where is the scope for the Reserve Bank of India for rediscount ?

Particularly the old and firmly established system of giving overdrafts and cash credits has been the prime factor which has gone against the practice of drawing bills. Statistics taken from the Balance Sheet of the biggest Scheduled bank will show the relative importance of the practice of overdrafts and cash credits to bill discounting.

TABLE C 2

THE IMPERIAL BANK OF INDIA LTD.

(as at 30th June, 1945)

ADVANCES

1.	Loans	Rs.	14,17,08,772— 5— 4
2.	Cash Credits and Overdrafts ...	„	46,15,45,893—13— 9
3.	Bills Discounted and Purchased ...	„	6,47,03,170— 4— 9
	TOTAL ...	Rs.	66,79,57,836— 7—10

From the above Table C2 it will be deduced that dealings in bills formed only about 8 per cent. of the cash credits and overdrafts given to business. In giving his evidence before the Hilton-Young Commission (1926) the late Mr. Benjamin Strong, Governor of the Federal Reserve Bank of New York, said : " If the development of banking in India takes the form of an overdraft account which produces no negotiable instrument which can be taken to a Bank of issue, certainly it will retard the functioning of the Bank of issue, which requires for its conduct that borrowing be on the best type of paper that the commercial banks get from their customers."* The opinion expressed by this world-famous banker is the ablest expression of the root cause of weakness of the Reserve Bank of India in playing its true part as a 'Lender of Last Resort'. Finally, as the indigenous banking has not yet come within the scope of the Reserve Bank of India, there is no hope for the Hundis (bills) to reach the Reserve Bank of India for rediscount.

3. POWER OF DIRECT DISCOUNT :—Apart from Rediscount many Central Banks have been empowered to discount *directly* with the public. This power has had its origin in the time of the great depression. In the United States, for instance, the Emergency Relief and Construction Act of July 21, 1932, provided for the first time that " in unusual and exigent circumstance " the Federal Reserve Board may authorize any Federal Reserve Bank to discount for any individual, partnership or corporation, notes, drafts and bills of exchange eligible for discount by member banks. It presupposes that these elements have not been able to obtain the required volume of credit from member banks.† This power, along with other liberal lending powers, was given to the Federal Reserve Banks to assist business in the economic programme of the New Deal. Further, in the autumn of 1937, when vigorous steps had to be undertaken to *counteract the credit contraction*, a drastic change in monetary policy became apparent and one of the steps taken was to relax the rules governing the eligibility of paper presented for redis-

* His answer to (Q) 15,416. Report of the Hilton-Young Commission.

† Even subsequent amendments to the Federal Reserve Act considerably extended the scope of the lending operations of the Federal Reserve Banks by empowering them to make loans *directly* to businessmen and institutions under certain restrictions. But the volume of credit extended thereby was comparatively small. At the end of 1935 the outstanding credits of this type did not exceed $32 million.—League of Nations: *Monetary Review*, 1936, page 35.

count to the Federal Reserve Banks which also were authorized to lend " against any asset which they find satisfactory ".*

A similar provision for *Direct discount* and making loans or advances is incorporated in the Reserve Bank of India Act which stipulates that when in the opinion of a special committee of the Central Board or the Governor, as the case may be, " a special occasion has arisen making it necessary or expedient that action should be taken under this section for the purpose of regulating credit in the interests of Indian trade, commerce, industry and agriculture," the Bank may (i) purchase, sell, or discount any of the bills of exchange or promissory notes specified in the Act, though such bill or promissory note *does not bear the signature of a Scheduled bank or a Provincial Co-operative Bank* or (ii) make loans or advances repayable on demand or on the expiry of fixed periods not exceeding ninety days against the various forms of security specified in the Act.†

It will be noted that there are two qualifications for undertaking Direct discount and making loans or advances : (i) that a special emergency has arisen, and (ii) that regulation of credit should be in the interest of trade, commerce, industry and agriculture. Under these circumstances, the normal stipulation that the commercial paper must bear an endorsement by a Scheduled bank (or a Co-operative Bank) is waived.

It cannot be gainsaid that such a provision for Direct discount is a serious breach of the principle that the Central Bank exists to play the part of a true Bankers' Bank, and that, being the nation's Bank, it should not undertake business which is likely to endanger its liquidity and thereby shake up the whole credit structure of the country. Happily, the history of the working of most Central Banks empowered to deal directly with the public has shown that such power is made use of under great restraint.

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* League of Nations: *Monetary Review*, 1935, page 48.
† The Act, Chapter II, Section 18.

CHAPTER V

Credit Policy is an essential part of Monetary Management

1. THE ESSENCE OF CREDIT POLICY :—Since credit plays a far more important part than currency in monetary supply in a country, the establishment by a Central Bank of its Credit Policy forms a vital part of monetary management. This policy translates itself in wielding those instruments which directly or indirectly assist a Central Bank to bring about, what Mr. W. Randolph Burgess so lucidly stated, as "*a thorough adjustment of the volume of credit to the volume of business.*"* Any maladjustment in this respect would make the volume of credit either more or less than what is legitimately required by business, and would result in sudden changes in the purchasing power of money. If it is more, it would lead to inflation leading to a rise of prices and foster undesirable speculation ; but if it is less, it would result in deflation, leading to a fall of prices, and depress business. Sudden and unwanted changes in prices bring about instability and uncertainty in business, inflict ruination on either the creditor class or the debtor class, create bitter friction between employers and wage-earners, make sudden changes in the distribution of wealth and result in vastest economic and social consequences. The history of prices demonstrates the devastating effects of changes in prices on the economic structure of various countries and lends emphasis to the need for continuous credit control. One aspect of the problem of the adjustment of the volume of credit to the volume of business consists in the establishment of an equilibrium in the supply of the Central Bank's *reserve funds* and the demand for them from the money market. By raising the price of the reserve funds which are needed by banks and business at a given time or by lowering it at another time as circumstances may necessitate, the Central Bank aims at equalizing the supply of the volume of credit to the legitimate demand for it, so that there is neither an excess nor a deficiency of the funds, and financial stability is maintained

* *The Reserve Banks and the Money Market*, page 168.

in the money market. But there are other phases too of the problem of credit policy. For instance, some commercial banks, having enough money, may not care to obtain credit at the Central Bank, and may be lending freely to the public who make a wrong use of the funds by throwing them on the stock exchange for speculative profits. Or, commercial banks may rediscount eligible paper or obtain advances from the Central Bank, which may later be utilized by either themselves or without their knowledge by their customers for speculative purposes. Such an abuse of the borrowing facilities which the Central Bank provides will have to be prevented or drastically corrected. In such cases the instruments to be utilized by the Central Bank will have to be different from that of merely adjusting the price at which the reserve funds may be purchased by commercial banks.

2. INSTRUMENTS OF CREDIT CONTROL :—In the past Central Banks have relied principally on two instruments of credit control ; namely, (1) manipulation of the *Bank Rate of Discount*, and (2) *Open Market Operations*. Particularly prior to World War I, the traditional instrument was the Bank Rate of Discount, as it had close relation to the free working of the International Gold Standard. It was the classic weapon of the Bank of England, for London held a unique position as the Banker for the world. But with the disappearance of the Gold Standard and the imposition of Exchange control by various countries, the arena in which the Bank rate could play a successful part was destroyed. And with needy Governments entering the money markets as constant borrowers, Open Market Operations have outclassed the working of the Bank Rate of Discount.

(i) THE BANK RATE OF DISCOUNT :—The rate of discount charged by a Central Bank is the official minimum rate per cent. charged for discounting or rediscounting first-class eligible bills and is called the *Bank Rate of Discount*. Whereas, the rate of discount charged by commercial banks to their customers for discounting their bills is called the *Market Rate of Discount*. If a rise or fall of the Bank rate brought about a corresponding rise or fall in the market rate and thereby in other domestic money rates, control of the Central Bank over the money market would be successfully established.

Historically, Central Banks have anxiously watched their *gold*

reserves. Generally, the flow of gold into or out of the Central Bank's reserves indicated the strength or weakness of the domestic economy of a country. It indicated whether business was flourishing or languishing, whether the credit situation was good or bad, and whether relaxation or imposition of control was necessary or not.

The *reserve ratios*, in fact, formed the *barometer* of Discount Rate policy. Assuming that the reserve ratio sank low as a consequence of the *outflow* of gold from the country the Central Bank atonce raised its Bank Rate of Discount to protect its gold ; and conversely, it lowered it when the reserve ratio went up. If there occurred an outflow of gold from the country, it proclaimed a serious disequilibrium in the country's economy and *narrowed the base for extension of credit*. The outflow of gold may have been due to an unusual reduction in exports or an increase in imports of goods resulting from a rise in domestic costs relatively to foreign countries or from other causes. Or the drain of gold may have for its cause a sudden withdrawal of foreign funds by foreign holders of them or domestic capital may be migrating in large amounts for speculative investments abroad or in the last analysis there may have occurred a ' flight of capital ' caused by a political panic. Whatever may be the factor leading to an outflow of gold, it is the Central Bank's reserve ratio that bore the first brunt of it and was a signal of changes in the domestic economic situation. On the other hand, a substantial *inflow* of gold led to a rise in the reserve ratio of the Central Bank by accretion of gold through commercial banks. It at once created a *stronger base for wider extension of credit* and cheapened money rates.

(A) EFFECTS OF RAISING THE BANK RATE :—Assuming then that a foreign drain of gold was taking place and it was found expedient to *raise* the Bank rate.

It leads to contraction of credit.—The immediate effect would be to make borrowing at the Central Bank *dear*. Commercial banks which are compelled to pay more for rediscount find their margin of profit eaten up and they abstain from rediscounting *bills* further. Thus, if the commercial banks hold bills which they have discounted at, say, 4 per cent. when the Bank rate was 3 per cent., and now the latter has been raised to 4 per cent., there is no profit in rediscounting these bills at the Central

Bank. Similarly, if businessmen are permitted to discount bills directly at the Central Bank, they too would be dissuaded from presenting them for discount. The same is true in the case of borrowing money. If businessmen were to borrow at the new higher rate, they would find their narrow margin of profit, on which they usually undertake commercial business, wiped out. A brake would therefore, be placed on the extension of credit and therefore on extension of business.

Market rates tend to rise.—Further, in case commercial banks, which fear that their cash reserves might fall below the required safe margin, have to borrow from the Central Bank, they would be compelled to pay the new higher rate. But they would undertake to do so only if they were able to charge a still higher price to businessmen for credit. Under the circumstances, if businessmen who are in urgent need of more credit still demand it from commercial banks, they would have to pay a higher price for it than before or cease undertaking additional business. And at this time, as gold would be flowing out of the country, there is bound to be relative scarcity of money. A combination of these factors would necessarily result in a *rise in the money rates* in the money market and lead to a curtailment of the volume of credit and a reduction in the domestic demand for investments in commodities. This would tend to depress prices, which would tend to discourage production, and if adjustment is possible, lead to reduction in wages.

Force the sale of commodities.—But a rise in the Bank rate not merely curtails the volume of credit and domestic demand for investments. It has also the tendency to force the sale of commodities by businessmen. It is to be remembered that in the normal course loans or advances are made to businessmen by commercial banks at a rate which is, for instance in India, *one per cent.* (or thereabouts) higher than the Bank rate and on condition that, if the Bank rate rises during the currency of the loan, the additional sacrifice will be shifted to the borrowers. As the Bank rate is raised, businessmen holding commodities would be forced to pay the new higher rate even for borrowings they have already made (before the raising of the Bank rate). They would therefore prefer to unload their stocks of commodities on the market at reduced prices rather than continue to pay a rate which would force them to sell their com-

modities at less than cost price. The result is a *fall in commodity prices.*

Force the sale of stock and shares.—The same is true of the sale of stocks and shares. They are also unloaded on the market by investors, and particularly so because they would find it more profitable to invest the proceeds in the discount market which has become a lucrative short-term market for investment. This would lead to a fall in the prices of shares and stocks.

(B) HELP FROM FOREIGN COUNTRIES :—

(i) *The Balance of Trade becomes favourable.*—The fall in prices of commodities makes the country a good market to buy from, but a bad one to sell to, so that exports are stimulated and imports are discouraged. And imports fall off still further because consumers can now buy commodities freely in the home market, as the prices have fallen. The result is that foreign indebtedness of the country gets reduced and *gold flows into* it, instead of flowing out of it.

(ii) *Gold is attracted.*—If the discount rate is raised, say, 5 per cent. in the country X (the country in question) whilst it remains at, say, 3½ per cent. in another country Y. The result would be that gold would be shipped from Y where it is cheap to X where it could earn more during the short period of a rise in the discount rate. Similarly, it would also make profitable the transfer of credits to X.

Further, as the rate is higher in X, businessmen in Y would buy bills on X empowering them to receive gold in X. The price of bills on X would therefore rise. Similarly business houses of Y residing in X would draw bills on Y and sell them in X, with the result that as the supply of bills on Y increases their price tends to fall. This, therefore, would tend to correct the foreign exchanges in X.

In course of time the operation of these factors would restore the equilibrium and gold would *return* to the country.

OTHER PRINCIPAL FACTORS LEADING TO RAISING OF THE BANK RATE :—Normally, one of the most frequent occasions on which a Central Bank raised the Bank rate was when exchanges moved against a country and the gold export point had nearly been reached. So that the Bank rate was a ready mechanism for correcting an adverse exchange. But at other times too the Bank rate had to be raised, as when money

flowed during the season to finance the crops or pay-rolls or holiday payments led to a heavy demand on the Central Bank's reserves. Further, when trade is booming and the speculative mania has caught hold of the market leading to the spread of false optimism, businessmen are drawn headlong into making contracts. Trade becomes intense, credit becomes inflated and banks on their part borrow from the Central Bank in increasing amounts, and the Bank's reserves are in danger of being depleted. To arrest the expansion of credit beyond the safe limit, the Central Bank has to take prompt measures one of which is to raise the Bank rate, so that contraction would result in as short a time as possible without disturbing the money market.

(B) EFFECTS OF LOWERING THE BANK RATE :—On the other hand, a continued *inflow* of gold would tend to create a disequilibrium in a country's economy in the opposite direction. When plentiful gold enters a country (i) it naturally cheapens money and (ii) widens the base for larger extensions of credit. The bank rate is lowered and thereby almost immediately all other rates closely knit with it. Commercial banks borrow heavily from the Central Bank to meet increasing demand for money from businessmen. A powerful stimulus is given to trade, production and investments and speculation gets a spur. Demand for commodities becomes brisk and the all-round boom *raises the domestic level of prices and domestic costs also tend to rise.*

When prices of commodities have risen, exports are discouraged but imports encouraged and the balance of trade is turned against the country. The exchanges become *adverse* to the country and gold flows *out* of it. Besides, a low Bank rate at home is a cheap market for gold for foreigners. They buy the gold and sell it in other countries where the Discount rate is higher. Gold therefore flows out of the country. All these factors combine to deplete the Central Bank's reserves and compel it to raise the Bank rate of discount.

OTHER PRINCIPAL FACTORS LEADING TO LOWERING OF THE BANK RATE :—When trade is inactive or unnecessarily depressed, but there is plentiful supply of money and at the same time in the judgment of the Central Bank a stimulus is required for business activity, the Bank rate would be lowered. This will tend to foster optimism in business and increase the demand for credit for productive purposes. Further, when in

the normal course, the balance of trade becomes favourable to a country and a steady inflow of gold takes place, it would naturally increase the supply of money and lead to a lowering of the Bank rate and cheapening of credit.

3. REQUIREMENTS FOR SUCCESSFUL APPLICATION OF THE DISCOUNT-RATE POLICY :—If the Bank rate policy has to bring forth a desired result it must be immediately effective and in full force. If it is to work itself slowly before it is assertive, it will never succeed in its aim—it would be too late to control monetary supply and credit. If the Bank rate has to have its full effect it postulates that the money market is so well organized that nearly *all* surplus funds seeking short-term investment are mobilized within its arena. If, for instance, out of 100 units of short-term funds seeking investment the money market is capable of pooling, say, only 60 units for such investment, then 40 units of funds will remain unaffected by a change in the Bank rate policy. In such a case, the money market will not automatically respond to changes in the Bank rate and the only indirect effect it may tend to produce on the credit situation would be purely psychological. Such is going to be the failing of Bank rate policy in India. With the indigenous bankers taking over short-term financing of commerce and industry in amount enormously greater than that undertaken by joint-stock banking, and keeping itself aloof from the orbit of Reserve Banking, the Bank rate policy will be able to envelop only a *faction* of the short-term finance seeking investment in the country.

A Central Bank is permitted by law or by convention to deal in the most liquid type of paper and the Bank rate policy relates to such paper. It is, therefore, necessary that such paper must comprise a very large majority of short-term dealings in the money market, if the discount rate policy has to be effective. But, if this is not the case, the differences between the rate of this *key*-paper and the rates of other papers should be so *narrow* and therefore sharply competitive in the market, that the moment the Bank rate is changed, its effect traverses the rates of other papers immediately. Unless, this condition exists the Central Bank cannot be the dictator, as it should be, in the money market. If, for example, A, A1, A2, A3, and A4 are five different types of paper used in the money market

and the Central Bank is empowered to apply its Bank rate policy to A only, then in order to give it complete control of the market, it should have immediate influence on the rates of A1, A2, A3 and A4. But this is possible only if the differences in the rates of these papers are very small and are consequently so competitive that short-term finance could be shifted quickly from the one to the other for investment. If the rates of the above papers were, say, 1 per cent., $1\frac{1}{2}$ per cent., $1\frac{5}{8}$ per cent., $1\frac{3}{4}$ per cent. and 2 per cent. respectively, a change in 1 per cent. of A must, like the switch-on of the electric current, permeate its influence in the other rates. But it is only in a highly organized money market operated by specialists in discount business that such narrowness in the rates of different papers and rapid mobility of funds for investment amidst various types of paper are obtained.

If the change in the Bank rate has to be effective in controlling the demand for credit on the part of merchants, dealers, producers and speculators, it is also necessary that they should be working on such *narrow margin of profits* that a raising or lowering of the Bank rate should have an immediate effect on the volume of their business. If, for example, the Bank rate is raised, say, by 1 per cent., or 2 per cent. and there is a corresponding increase in other interest rates, demand for credit may still continue to be unaffected, if the margin of profits of demanders is wide enough to absorb the increase in the rate. It would only result in reducing the margin by 1 per cent. or 2 per cent. of the average businessman who might still continue to expand his business. Indeed merchants in particular are very sensitive to small changes of the rate of interest, for they work on the principle of a narrow margin of profits accompanied with a large turnover of business. The merchants are in a sense in a 'strategic position'.* If the rate of interest is raised sufficiently to eat up the margin of profits of merchants, they would be compelled to reduce their stocks. They cut down their orders to producers. Production in turn is cut down and *costs therefore rise*. But to induce sales of goods prices have to be reduced. So that the incidence of the higher rate of interest is diffused among the merchants and producers. The opposite is the situation in case of a reduction in interest rates. But generally,

* Gottfried Von Haberler: *Prosperity and Depression*, page 5.

industries ought also to work on a narrow margin of profits so that they can be readily influenced by a change in the interest rate bringing about a corresponding change in industrial costs and therefore in profits. Costs of production would rise or fall because producers would have to pay a higher or lower price for obtaining short-term credits for financing current operations.

But if a change in the Bank rate has to have its full effect on prices through its influence on the demand and supply of money on the part of merchants, dealers, producers and speculators, there should be "a substantial measure of *elasticity* in the economic structure."* Such elasticity existed in England before World War I and it was responsible for the effects of a change in the Bank rate to be transmitted to the various elements. If there is rigidity of any kind such a Rationing of commodities or controlled Economy regulating prices, wages, transport and so on, it will prevent changes in interest rates from playing their part in influencing business conditions. There should be no restrictions or hindrances placed in the way of a change in money rates imposing its effects through various channels on business conditions. The greater is the Government's interference in the money market by means of instruments such as managed currency or by open-market operations, the weaker will be the effects of changes in money rates on business conditions.

Looking back on the successful working of the Discount rate policy in England before World War I, we find that the principal factor that led to its success was the great convention built up by commercial banks to base their money rates on the Bank rate. The rates rose in conformity with a rise in the Bank rate and fell with a fall in the Bank rate. Conventions of the Constitution rather than laws have been responsible for building up a healthy democracy in England. Similarly, conventions have knit together the various elements of the London Money Market in such harmonious working that it has stood her trials in grave emergencies smoothly and with success. Willing co-operation of the banks with the Bank of England and their faith in her leadership were assets in helping the Bank to control credit and monetary conditions with a substantial measure of success. Voluntary submission on the part of the banks rather than coercion on the part of the Bank has been the key to the splendid orga-

* De Kock: *Central Banking*, page 179.

nization of the London Money Market. But this demands a spirit of service and of sacrifice on the part of the banks in the wider interest of the nation—a subordination of their own interest to that of the nation.

4. FEEBLE INFLUENCE OF THE INDIAN BANK RATE :—As stated previously, the Bank rate of discount in India has been of little or no significance in controlling credit. It has been stagnant at 3 per cent. during the decade of the existence of the Reserve Bank of India. In the first place, if the Bank rate has to be effective it will be absolutely necessary to bring the indigenous bankers within the Reserve Bank link, for they take up a colossal share of financing Indian trade. Unless that is done, assuming the Bank rate has had its full influence on the joint-stock money market, it will only be successful in controlling a *fraction* of the total short-term funds that seek investment within the country. At present the Bank rate will force itself on the indigenous money market only when the Shroffs have already exhausted their resources in investments and still feel the necessity for further obtaining funds for investments in legitimate short-term business. It is only when the marginal ones are pushed into the Reserve Bank either directly or indirectly through Scheduled banks that the Bank rate's influence will be transmitted to the Shroffy market. But even in such cases the volume of money that it will control will be too small, and it will tend to bring within its sphere a few big Shroffs in the main port cities only. The innumerable Shroffs who stud every part of India will still remain unaffected by the Bank rate. The effect will be on a few marginal Shroffs only and *not on the marginal amounts* that seek investment in the country. This fact alone puts a damper on the Bank rate's power to control monetary conditions in India.

Secondly, apart from this fundamental weakness, where is the necessary organization of the money market ? We have no specialists operating in short-term financing who would work as expert intermediaries between borrowers and lenders and who would be in a position to scrutinize correctly the credit-standing of the parties and to mobilize a major part of short-term funds seeking investment. This duty has, at present, devolved on the Scheduled banks who either deal directly with businessmen or utilize the services of some Shroffs as intermediaries to tap the

sources of borrowers demanding short-term finance, for this is the only method by which the Scheduled banks can hope to reach the bazaar. But there is a limit to such tapping. These intermediaries—the preferred Shroffs—are individually given certain maximum limits upto which a Scheduled bank would be willing to advance money or discount bills of customers brought by them. The limits vary with the credit-standing of each Shroff. But, if an intermediary Shroff X has a customer A who is capable of offering the security required by a Scheduled bank and who could, therefore, borrow or discount at a relatively low rate, and another customer B who has relatively less security to offer but is willing to pay a higher rate for finance, he would certainly take A to a Scheduled bank but he would take B to another Shroff (instead of a Scheduled bank) who is willing to take the risk of lending money which he does readily and quickly on his own terms. This is why Shroffy business deprives joint-stock banking of lending business and forms one of the essential weaknesses in attracting short-term borrowers towards the joint-stock market. Conversely, it is in the readiness of the Shroff to undertake the risk of loaning that lies the germ of his success and makes him an indispensable element in the credit organization in the country. Insistence by joint-stock banks every time on full security, although the soundest principle of banking, is unfortunately in India a factor that chases business away from them. Consequently, in the absence of specialized operators each possessing intimate knowledge of clients within his own group or sphere of intimacy and *himself undertaking short-term financing therein*, the Scheduled banks cannot develop a substantial business link between the bazaar and themselves; and unless this condition is fulfilled, supply and demand for short-term funds cannot be brought into equilibrium in the joint-stock money market. This accounts for wide variations in certain rates. If there are specialized operators who, on the one hand, themselves undertake short-term loaning to businessmen, and on the other borrow from banks the necessary finance, the banks would be able to shift the risks of business on the operators advantageously and at the same time place the largest amount of surplus funds in the market.

A third factor that tends to make the Bank rate ineffective in India is the dearth of bills for discount in the joint-stock market.

Statistics show that bill discounting is steadily declining. It was explained in Chapter IV that this has been due to the age-long practice of giving overdrafts or cash credits which takes up a lion's share, and an increasing one, of financing business in the country. This is a national characteristic of banking in India, including the indigenous banking. In fact, since 1930 a tendency is very strongly evident that, in places where Scheduled banks have started their branches, cash credits and overdrafts have been drawing in business for them at the expense of hundi (bill) discounting with the Shroffs. At the same time, as the head offices of these banks are able to distribute some of their surplus funds among the branches, this distribution automatically reduces the scope for bill discounting but prepares the ground for extension of overdrafts and cash credits. In face of these facts, no useful purpose would be served in being goaded on to an effort at developing discount business when the organic tendency is towards the development of overdrafts and cash credits.

Much rather develop a convention to base the rates of overdrafts and cash credits on the Bank rate in order to make the latter effective. In fact, during the last twelve years there has been introduced by some of the big Scheduled banks a general practice of charging for a pro-note or for overdrafts and cash credits 1 per cent. over the Bank rate. Similarly, mutual agreements have been entered into by certain of these banks, in order to avoid unnecessary competition, not to advance in Provinces against commodities like sugar, below a particular rate. Such agreements are laudable. They will be the healthy nucleus that will help to build up an organized money market in India. If the deposit rates charged by Scheduled banks, which vary so much at present, were to be fairly *uniform* by agreements reached or conventions entered into, then uniformity can be transmitted to rates charged for call and advances and a close relation established between these rates and the Bank rate. The *nearer* these rates for call and advances are brought to the Bank rate, the stronger will be the influence of the Bank rate on them and thereby on monetary conditions within the country. Then also will be evident the psychological value of the Bank rate on other rates. There are happy portents. Only if the Big Three take a lead in this direction, their example

will soon be followed by other Scheduled banks.

At the same time it is important to note that if traditions are to be built up and close co-operation between the Scheduled banks and the Reserve Bank of India is to be achieved, there ought to be greater concentration of banking resources in the hands of a few banks. In England, amalgamations of certain joint-stock banks in the 'Big Five' (with thousands of branches) was the intrinsic cause which led to successful adherence to tradition and close co-operation between them and the Bank of England. Similar amalgamations in India would result in building up a forceful tradition which would also be helpful in enhancing the prestige of the Reserve Bank of India. Why do not the Imperial Bank of India Ltd., the Central Bank of India Ltd., and the Bank of India Ltd., lead the way in this direction to form "The Big Three" to knit up a healthy money market in India ?

CHAPTER VI

Open Market Operations

1. ESSENCE OF OPEN MARKET OPERATIONS :—Open Market Operations relate to the dealings of the Central Bank *directly* with the market and not through commercial banks. Broadly stating, these dealings consist of a deliberate and *direct purchase or sale of bills and securities in the market* by the Central Bank as occasion requires. But since 1930 Open Market Operations dealings in Government securities (both short and long dated) have been undertaken by various countries in such colossal amounts and so frequently that the term 'Open Market Operations' has by practice been confined to those referring to Government securities only. The Central Bank, so to say, 'jumps' into the market either to purchase or to sell Government securities any time in order to force its control over credit and on monetary condition.

In the case of Rediscount operation, the Central Bank waits for the market to take the initiative. Unless the market approaches the Central Bank for credit, the latter cannot take action. The application for credit comes *directly* from the market. Whereas in the case of Open Market Operations it is the Central Bank that takes the initiative without waiting for the market. What the volume of credit in the market shall be at a particular time is determined *indirectly* for the market by the Central Bank, which enforces its will on the market.

2. EFFECTS OF OPEN MARKET OPERATIONS :—The effects of Open Market Operations on the Market may be explained briefly thus :

(*a*) *Effects of the purchases.*—First, when the Central Bank *purchases* Government securities in the open market it pays cash or cheques to the sellers, either the public or the commercial banks. Some part of this amount may enter circulation for investment but most of it will be deposited with the commercial banks who, in turn, either by law or convention deposit a certain percentage of it with the Central Bank. Deposits of commercial banks with the Central Bank will thereby increase. If com-

mercial banks are themselves the sellers of Government securities, then their accounts with the Central Bank will be credited directly, thereby increasing their reserve deposits. The result will be that the *credit base will be widened* and the ground will be prepared for a considerable extension in the volume of credit. Thus there are two direct effects : (1) Cash is pumped into the sellers' deposits with commercial banks, and (2) the banks' reserve deposits with the Central Bank are increased. The net result will be an increase in the supply of money and a consequent fall in money rates which should tend towards a substantial extension of credit, prices would tend to rise and a spur would be given to business expansion.

(*b*) *Effects of the Sales.*—Conversely, when Government securities are *sold* by the Central Bank, the purchasers, who are commercial banks or their clients, pay for them. (i) If commercial banks are themselves the purchasers their accounts with the Central Bank will be debited directly and their reserve deposits will be reduced, thereby *contracting the credit base.* (ii) If individuals purchase the securities and pay cash, their deposits with the commercial banks will be reduced. If they pay by cheques the banks' deposits with the Central Bank will tend to be debited. The result will be a reduction in monetary supply and a rise in money rates which will lead to a contraction of credit.

To summarize, the effect of Open Market Operations is (1) by means of purchases of securities, to increase monetary supply and thereby bring about a fall in money rates which would induce borrowings and in course of time lead to a rise in prices and end in business expansion, and (2) by means of sales of securities to decrease monetary supply, which would lead to a rise in money rates and dissuade borrowings, which in turn would in course of time lead to a fall in prices and end in business contraction. Increasing or decreasing the quantity of cash is expected to have its direct effect on prices.

3. CONDITIONS ON WHICH OPEN MARKET OPERATIONS WILL SUCCEED :—As stated above, Open Market Operations are undertaken to have their direct effect on the cash reserves of commercial banks. The Central Bank, by Purchase Operations will try to bring about a proportionate increase in the quantity of money and by Sale Operations a

proportionate decrease in the quantity of money with the object of affecting the credit situation. But such desired results can come about only ***in the absence of disturbing factors.***

(1) If, for example, when Purchase Operations are undertaken with a view to pump money into circulation in order to stimulate domestic business activity an inflow of gold takes place, the additional money may be utilized for purchasing the gold instead of stimulating business. Again, it may even happen that some attractive investment in a foreign country may drain away the increased quantity of money. There is also the possibility of the additional money being hoarded away in part or in full or invested on the stock exchange. Similarly, in the case of Sale Operations, an outflow of gold or return of notes from the hoards may go counter to the picking up of money from circulation.

(2) Further, consideration must also be given to the velocity of circulation of bank deposits. Unless this velocity remains constant, increase or decrease in the quantity of bank deposits will fail to produce the effects which the Central Bank has desired by a Purchase or Sale Operation. The most important element in monetary technique which cannot be forecast or controlled is the velocity of circulation of bank deposits, because as Mr. De Kock states, "it is largely the resultant of human reactions."* In the normal course, in time of booming trade, optimism rules and the velocity of bank deposits rises in spite of raising the money rates substantially ; and in time of depressed trade, pessimism rules and the velocity falls in spite of a substantial cheapening of the money rates. The history of trade cycles has shown numberless cases in which a reduction in money rates had resulted in a greater reduction in the velocity of circulation of bank deposits, because of the fear and uncertainty which prevailed in business. On the contrary, the velocity of bank deposits had been increased in face of great hardening of money rates and formed a factor in bringing about a crisis, as was the case during the Stock Market Boom in the United States of America in 1929. In fact, business psychology at particular times has been responsible for depressing or accelerating the velocity of circulation of bank deposits and has been a principal factor in giving aid to depressions and booms. Such disturbing factors, then, are likely to offset the effects of Open Market

* *Central Banking*, page 221.

Operations.

(3) Both lenders and borrowers should be induced to act favourably or unfavourably in the same direction. If commercial banks are anxious to lend because the credit base has increased, borrowers must also be willing to borrow at the same time. On the contrary, when the commercial banks are unwilling to lend as the credit base had decreased, the borrowers must also be unwilling to borrow. If by these Operations, an increase or decrease in the cash reserves brings about a widening or narrowing of the credit base, the commercial banks must be willing to increase or decrease the lending business correspondingly. But pessimism or optimism in business due to various factors, existing or anticipated, may dissuade banks from extending or contracting credit according to the dictates of the Central Bank. In short, the commercial banks may be the tools of circumstances. Similarly, business must also respond to changes in quantity of money offered. Banks may be anxious to lend credit at cheaper rates because the credit base has increased, but demand for credit may not increase at the same time. It is easy to take a horse to the water, but it is difficult to make him drink it. In the same way, businessmen cannot be coerced into taking loans at cheaper money rates if they are unwilling to do so. Willingness or unwillingness to demand credit depends on various fortuitous circumstances. Is the market favourable for taking further risks in business, whether for production, trade or speculation ? It may not be so. On the contrary, when money rates have risen due to a decrease in the credit base, the demand for credit on the part of producers, traders and speculators may still continue or even increase instead of being reduced, if optimism in business prevails and the future looks brighter to induce them to take further risks.

CHAPTER VII

New Machinery for Exchange Stabilization

1. THE GOLD STANDARD PREREQUISITES :—Under the Gold Standard the domestic circulation as well as international payments consisted mainly of gold. For its successful working there were three fundamental provisions which prevailed :—

(i) there was complete freedom of gold movements between Gold Standard countries,

(ii) there were no artificial impediments in the way of commodities moving freely between these countries,

(iii) a Central Bank existed in each of these countries in order to take an active part to regulate the Standard as occasions required. When gold, like the pendulum was observed or was expected to move with unwanted speed into or out of a country, it was corrected by a Central Bank by a gentle push in one direction or another.

2. CENTRAL BANK'S ASSETS :—The Central Bank's assets consisted of (*a*) domestic assets, and (*b*) international assets, that is, gold and foreign exchange. And ***changes in the Central Bank's acquisition of international assets*** played a vital influence on the amount of money which was made to circulate within the country. This meant that the credit policy of a Central Bank had to be regulated in accordance with changes in the supply of international currency. The Central Bank had to play an important role in this connection.

3. DOMESTIC CREDIT STRUCTURE HAD TO RESPOND TO CHANGES IN BALANCE OF INTERNATIONAL PAYMENTS :—It is a change in the balance of international payments that brought about a change in the supply of international currency. When gold flowed ***in*** as a result of a favourable balance, it created a ***wider base for extension of credit*** and the Central Bank took pains to ***cheapen credit***. But when gold flowed ***out*** owing to an unfavourable balance, it ***narrowed the credit base*** and the Central Bank had to make credit ***dear***. This expansion or contraction of domestic money by the Central Bank depended on its ***reserve ratio***, that is, the ***ratio of gold to liabilities***. Assuming this ratio to be, say, 25 per cent. (25 of

gold : 100 liabilities), any net increase in the gold reserve was expected to create a *four-fold* expansion in the total credit base, and any net decrease in gold reserve was to result in a *four-fold* contraction of the total credit base. This ratio of gold to liabilities oscillated the quantity of money in a country. But a *change in the balance of international payments* itself used to unhinge the ratio.

4. THE "RULES OF THE GAME" :—The regulation of Central Bank credit, having for its basis the *cover ratio*, could be fulfilled only by increasing or decreasing the Central Bank's domestic assets with any increase or decrease in its gold reserve. The principal weapons used by the Central Bank to bring about changes in the quantity of domestic assets in accordance with this principle were : (i) *The Bank rate of discount*, and (ii) *Open Market Operations*. These were what were known as the "*Rules of the Game*" by which a Central Bank wielded its domestic monetary policy. They applied not merely to gold movements but equally to changes in a Central Bank's foreign balances under the Exchange reserve systems such as the Gold Exchange Standard or the Sterling Area. "Their object, above all, was to secure quick and continuous adjustment of international balances of payments."*

If in a country there was an *active* balance of international payments it was accompanied by an *inflow* of gold, which was normally to be followed by a lowering of the money rates, and which in turn was to result in an *expansion* of the domestic money supply. And this expansion of the money supply was expected to bring about a rise in domestic costs and a rise in prices and increase in incomes. In turn, a rise in prices was expected to stimulate imports but to discourage exports, thus leading to an *outflow* of gold. The original inflow of gold which set the operations in motion in one direction was now replaced by an outflow of gold. Thus ran a chain of events one leading to another in almost rhythmical succession and bringing about an adjustment of the international balance of payments. The gold-receiving country reached the stage of becoming a gold-paying country.

On the contrary, when there was a passive balance of international payments, it was accompanied by an *outflow* of

* League of Nations : *International Currency Experience*, page 67.

gold which would be followed by a *raising* of money rates, which in turn was expected to result in a *contraction* of money supply. And this contraction of money supply was expected to bring about *a fall in domestic costs and a fall in prices and a decrease in incomes.* The fall in prices would tend to discourage imports but to stimulate exports. Gold, therefore, flowed *into* the country instead of flowing out of it.

In this way, the expansion of credit in the gold-receiving and the contraction of credit in the gold-losing country were intended to affect prices and incomes in such a way as " to close the gap in the balance of payments which had given rise to the transfer of gold."* By such mechanism the adjustment in the international balance of payments was supposed to take place. Here then rested the *equilibrating* mechanism brought about by the Gold Standard 'rules of the game', and the Central Bank was to play a vital role in setting the adjustment mechanism into motion by *changing the volume of domestic money in accordance with the balance of international payments.*

5. FAILURE OF " RULES OF THE GAME " :—During the years preceding 1914 this adjustment mechanism, working according to the 'rules of the games,' sailed smoothly. But statistical investigations undertaken during the years that followed 1914, have in numberless instances falsified the faith of the 'Classical' view in this almost automatic working of the equilibrating mechanism. This was particularly true of the inter-War period. The 'rules of the game' required that any increase or decrease in the international assets of the Central Bank must be followed by a *parallel* increase or decrease in domestic assets. But a close statistical study made by the League of Nations in the behaviour of international and domestic assets during the years 1922 to 1938 has shown that these assets moved far more in the *opposite* than in the same direction, from year to year. Of the 382 observations made regarding the movements of both these assets, 60 per cent. were in the opposite direction (that is, domestic assets moved in the opposite direction to international assets), and only 32 per cent. moved in a parallel direction; the remaining showed that domestic assets either remained constant or changed while international assets remained constant.

* League of Nations: *International Currency Experience*, page 67.

These observations concerned yearly intervals. But, it is possible that if some time were allowed for domestic assets to work their way in conformity with the movements of international assets, such an inverse correlation would tend to disappear, for during the time-lag the 'rules of the game' may be operating. In fact, it was natural to expect that there would be a time-lag in the process of adjustment.*

But the fact remains that '*neutralization*' ruled during all these years and led to the collapse of the machinery of 'rules of the game.' Such neutralization was either (i) automatic, or (ii) deliberately undertaken by the Central Bank in the interest of its domestic credit policy or by a Government machinery such as the Exchange Equalization Account of Great Britain.

(i) *Automatic Neutralization.*

The automatic tendency towards neutralization was observed to be very strong on many occasions. For example, during some years when an inflow of gold took place in the United States of America, there was such a great liquidity in the market that, as stated previously, member banks considered it prudent to repay their indebtedness to the Federal Reserve Banks. This, indeed, has been the normal practice of member banks. The result was that, when at the same time there was an increase in gold with the Federal Reserve Banks, there was a decrease in borrowings by the member banks and in domestic discounts and advances in the market. Thus the inflow of gold was partly offset by the action of member banks. Similarly, in many countries an outflow of gold, which would normally have resulted in a contraction of credit, was offset by an increase in borrowings by commercial banks from the Central Banks. Such have been the facts.

There was another factor which was responsible for the '*inverse correlation*' of the Central Bank's international and domestic assets during those years, particularly during 1925-28. When the Gold Standard was restored in many countries, private short-term funds began to move freely between one country and another to take advantage of differences in rates. Whenever gold moved out of a country owing to a passive balance of

* "Such lags are natural since one of the very functions of an international cash reserve is to give the country a breathing-pace in which the required adjustments can be accomplished more gradually than would otherwise be necessary."—League of Nations: *International Currency Experience*, page 70.

payments, and the Central Bank raised the Bank rate, or undertook Sale-Open Market Operations in order to bring about a *concurrent change* in its domestic assets, the private short-term capital flowed in from gold-receiving countries, which had lower interest rates, to this country which had higher rates. So there occurred an increase in international assets at the expense of domestic assets, which came in to offset the efforts of the Central Bank to bring about parallel changes in its domestic assets according to the 'rules of the game.' Similarly, when a Central Bank lowered the Bank rate or undertook Purchase-Open Market Operations it made the domestic money market less attractive to foreign funds which left the country for investments abroad, and as a consequence led to a fall in international assets and a rise in domestic assets. Although such movements of funds attracted by higher interest rates were 'equilibrating' in their effects, in the sense that the gold-losing country tended to receive back the gold quickly, they, on the contrary, tended to create *opposite* changes in the Central Bank's international and domestic assets. Such was the experience in countries like Germany, Austria, Bulgaria and Czechoslovakia, where these assets showed *negative* correlation during the period 1924-29.

(ii) *Deliberate offsetting by Central Banks.*

(*a*) *Before the Collapse of the Gold Standard* :—It is important to remember that during the nineteen-twenties, movements of short-term capital had already begun to be abnormal and therefore disequilibrating in their effects, and had as a consequence to be deliberately offset by various Central Banks. For instance, in the United Kingdom, during the six years following the return to gold in 1925, "the published returns of the Bank of England points to a systematic policy of neutralization."* Similarly, in the United States the Federal Reserve Board had to neutralize the enormous gold imports, although a part of it occurred automatically. The imports of gold made the market very liquid and member banks' borrowings from the Federal Reserve Banks were as a consequence much reduced. In fact, member banks paid off their indebtedness to the Federal

* League of Nations: *International Currency Experience*, page 75. In a Report to the Gold Delegation to the League of Nations the evidence was summarized as follows: "The inspection of the Bank return shows that the Bank has attempted, within certain broad limits, to stabilize the total volume of credit available to the English economic system by offsetting the gold losses by *an increased holding of securities*, and at times when gold was flowing in fairly freely, offsetting the increased supplies of gold by a reduction in its earning assets."

Reserve Banks. But various deliberate steps were taken to further offset the imports of gold. For instance, the Federal Reserve Banks reduced of their own accord their amounts of domestic assets, and at other times they prevented the imported gold from entering circulation by issuing gold certificates in its place.

(*b*) *After the collapse of the Gold Standard in September, 1931* :—However, the crucial stage was reached from the time the Gold Standard completely collapsed in September 1931 in England and as a result in most countries of the world, owing to abnormal movements of short-term capital. These movements became menacing in their effects and Central Banks were compelled to strain every nerve towards neutralization. Throughout the period 1930-39 deliberate neutralization was a common feature. Considerable factors conspired to bring about the feverish and abnormal movements of short-term funds which produced devastating effects on the balance of payments and on the financial stability of various countries.

Gold movements extending from the middle of 1931 to the end of 1932 were largely the result of general *panic withdrawals of capital*. The colossal movements of funds between the end of 1932 and the end of 1936 took place in the United Kingdom and the United States of America, and swelled the reserves of these countries. *Apprehension regarding the exchange value of the currencies* of countries like France, which remained attached to gold, was the most important single factor operating at different times in bringing about the flight of domestic capital from these countries, particularly France, to those which had adjusted the values of their currencies, chiefly the United Kingdom and the United States of America. For instance, the legal devaluation of the Dollar in the beginning of January 1934 was accompanied by a wave of distrust in the Gold Bloc countries leading to flights of capital to the United States of America. On the contrary, sudden repatriation of short-term funds by France and other countries from centres like London brought these financial centres to the verge of collapse.

Speculation in currencies was also an important cause in the abnormal movements of funds. The development of the *forward market* in exchanges since the European financial crisis of 1931 gave a new impetus to speculators to operate in currencies.

Speculative raids, international in scope, were numerous during the years 1931 to 1936, particularly in the currencies of France and other Gold Bloc countries, and resulted in the criss-cross movements of funds and blew these countries off gold and destroyed their economic structure. But the devaluation of the Gold Bloc currencies at the end of September 1936 did not check the movement of funds to the United States. The attraction of rising share prices in the United States seemed to have become the predominant influence on the inflow of capital in the latter part of 1936.*

6. NEW MACHINERY OF EQUALIZATION OR STABILIZATION FUND :—An entirely new machinery had to be invented to combat the terrors of these erratic and colossal movements of short-term funds which came to be known as 'hot money.' It was the system of Exchange Equalization or Stabilization Fund, which represented an important departure from traditional methods.† Several countries had introduced such Funds, the typical of these being represented by those in the United Kingdom and the United States of America.

(a) *The Exchange Equalization Account in Great Britain* :—The first of these Funds was set up in the United Kingdom in April 1932, after the devaluation of Sterling, and was named the "Exchange Equalization Account." It consisted mainly of assets in domestic currency. "It was also a secondary reserve of gold and foreign currencies designed to insulate the domestic credit system from disturbances arising from the ebb and flow of foreign short-term funds.‡. The Fund was intended to *equalize or smooth out* fluctuations in the foreign exchanges due to erratic movements of capital and the disturbing activities of speculators. But its principal function was the *offsetting* of short-term capital movements so that they were *prevented* from affecting the cash basis of the domestic credit structure.

Stated simply, the Fund or the Account met an *inflow* of foreign balances by the *sale* of Treasury bills to the money market of which a large part was to the commercial banks ; the Sterling resources thus obtained were used for purchasing the foreign

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* League of Nations: *Monetary Review*, 1938, page 21.

† "An Exchange Stabilization Fund is a collection of assets segregated under a central control for the purpose of intervention in the exchange market to prevent undesirable fluctuation in exchange rates." League of Nations: *International Currency Experience*, page 143.

‡ League of Nations: *World Economic Survey*, 1936-37, page 28.

balances which were, as a rule, converted by the Fund into gold. *Thus the foreign balances were picked up in time and thereby prevented from affecting the domestic credit system*. The Sterling paid by the Fund for the purchase of gold normally returned to the commercial banks as deposits or to be invested in Treasury bills. If the Sterling were invested in Treasury bills the internal credit structure would be unaffected, as gold exchanged with Treasury bills. But if most of the Sterling were kept as deposits, the effect of such operations on the banking position would be to increase Treasury bill holdings and deposit liabilities of the commercial banks, while leaving their cash reserves unchanged.*

The process was reversed in the case of an *outflow* of foreign balances. In this case, the Fund sold gold and with the Sterling so obtained, *repurchased*, in effect, the Treasury bills from the commercial banks. The Sterling given away by the purchasers of gold returned to the commercial banks as deposits. By these operations the amount of cash held by the commercial banks was unaffected but the Treasury bills and deposits declined.†

It may be noted that the price at which the gold was purchased or sold was not fixed but was variable at the discretion of the Account. The mechanism was essentially similar to Open Market Operations of a Central Bank by which, under the Gold Standard, movements of gold were offset.

Since the foreign funds would be added to or withdrawn from deposits with the commercial banks, it was found necessary "to integrate the operations of the Account with the machinery of the Central Bank upon which these deposits ultimately depend. The necessary link has to be found in the United Kingdom by varying the fiduciary note issue when the Bank of England buys gold from the Account."† Thus, when the Account had operated to offset the imports of gold and found that it was still necessary to widen the credit base, *it sold a part of the purchased gold to the Bank of England in exchange for securities and the Bank was enabled to issue notes against this new gold*. If, however, it was imperative, as a result of the offsetting operation, to narrow the credit base, the Account *purchased* gold from the

* League of Nations: *Money and Banking*, Vol. I, 1936-37, page 52.

† League of Nations: *World Economic Survey*, 1936-37, page 28.

Bank of England in exchange for securities. To illustrate, in the summer of 1936, there had been an inflow of funds, which was associated with the hoarding of Sterling notes in France. The Account neutralized this by selling Treasury bills to the market in London, which had the effect of tightening the short-term interest rates, as there was substantial contraction of notes. At the same time, the commercial bank's cash was reduced by taking up Treasury bills sold by the Account. In order to give relief to both the market and the commercial banks, the Account sold gold to the Bank of England which issued additional notes against it. Further, in December 1936, France repaid a banking credit in gold to London. The Account purchased this gold from the commercial banks by the usual process of selling Treasury bills. At this time, the Account already had considerable gold, and, therefore, sold £65 million worth gold (at the old valuation) to the Bank of England. At that time "there was no reason to offset the shrinkage of the commercial banks' cash."* So the Bank of England neutralized the greater part of the new purchase by reducing £60 million in the notes issued against securities and increasing £65 million in the notes issued against gold. So that new gold worth only £5 million remained in the reserves as additional credit base.†

Yet another technical method was adopted by the Account. In May 1938 repatriation of French capital took place from London and naturally affected the London deposits which were reduced by £99 million. This reduction did not consist of an equal amount of foreign deposits. A large part of the outflow was effected through sales of British securities in the London market. Those who purchased these securities paid for them with bank deposits. This led to a heavy reduction in domestic deposits which was bound to affect the domestic credit situation.† The Account, therefore, sold gold and foreign exchange to the Bank of England and with the Sterling so obtained repaid Treasury bills, thus swelling the deposits directly and neutralizing to a considerable extent the contraction which had taken place.

Further, during the last three months of 1938 the exodus of foreign 'hot money' from the United Kingdom to the United States continued at a rapid rate due to the fear of a general

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* League of Nations: *World Economic Survey*, 1936-37, page 28.

† League of Nations: *Monetary Review*, 1938-39, page 33.

war. This outward movement led to a decline in the Sterling exchange which itself became a motive for the withdrawal of funds. To support the exchange in the face of this pressure the Exchange Equalization Account was forced to dispose of almost half of its gold which accumulated during earlier years. But on 6th January 1939, there followed a measure of far-reaching importance for the external value of the Pound Sterling. Gold worth nearly £350 million (at the current price of gold) was transferred from the Bank of England to the Exchange Equalization Account. This led to a heavy increase in the fiduciary note issue, and as it was intended to effect a permanent increase in it, new legislation had to be passed in February—The Currency and Bank Notes Act of 1939—empowering the increase of the fiduciary issue to a 'normal' level of £300 million. At the same time this Act provided for a weekly revaluation of the Assets of the Issue Department. The transfer of gold from the Bank of England to the Exchange Equalization Account was made at the time, when the bulk of foreign hot money was believed to have already left London ; but it afforded a striking proof of the determination of the authorities to support the value of the Pound at the desired low level.

(*b*) *The Exchange Stabilization Fund of the U. S. A.* :—The Exchange Stabilization Fund established on January 31, 1934, in the United States of America had operated with methods very different from those of the Exchange Equalization Account of Great Britain. *Originally*, the assets of this Fund consisted not of domestic currency but of *gold*. This amounted to $2,000 million at the new provisional parity and representing part of the book profit on the revaluation of the gold stock. As the Fund possessed no domestic currency with which to purchase the inflowing gold, the Treasury financed its gold purchases by obtaining Dollars from the Federal Reserve Banks in *exchange for gold certificates* handed over to them, and which were equivalent in value to the purchases of gold. For nearly two years this mechanism was used to neutralize the imports of gold. But handing over to the Federal Reserve Banks gold certificates led directly to an expansion of the credit base. Later, however, in December 1936, it was *equipped with Treasury bills* which could be used to supply Dollars with which to buy the incoming gold. By segregating this gold, the Fund was in a position to prevent the

inflationary effects that would have resulted by its inflow to the United States. But the Fund was faced with a continuous inflow of funds and 'acted as a pipe-line for transmitting gold to the Reserve Banks, where it added continuously to the *excess reserves* upon which credit could be expended.'*

However, the *accumulation of unused cash reserves* by the banking system of the United States represented the "*off-setting,*" which, in the United Kingdom, was the function of the Exchange Equalization Account. The refugee-funds which entered the United States, particularly during the years 1934-36, were accumulated with banks as *excess reserves* and were not allowed to be absorbed into the domestic credit structure and thereby provided the guarantee that they could be repatriated easily and without causing any disturbance to the money market. In fact, the excess reserves may be regarded as a form of 'sterilization.' The proportion of gold reserves to total assets of the Federal Reserve Banks rose from 180 (Index number) in 1934 to 320 (Index number) in 1937. Similarly, the ratio of Central Bank gold reserves to total sight liabilities increased from 64.8 per cent. in 1929 to 102.5 per cent. in 1937. These facts may be regarded as an act of sterilization.

The successive *increases* in the *reserve requirements* of the member banks of the Federal Reserve System may be regarded as yet another form of sterilization of gold. When the enormous inflow of gold swelled the reserve balances of the member banks to exceptionally high levels, the *legal minimum cash ratios were doubled* from August 1936 to May 1937. This was designed not merely (i) to prevent injurious credit expansion, but also (ii) to immobilize the greater part of the excess reserves as cover for foreign funds held in the United States. By the doubling of reserve requirements an additional amount of nearly $3,000 million was frozen for the purpose of sterilizing a corresponding amount of gold by the last quarter of 1937.† So long as member banks had a volume of reserves far in excess of legal requirements, the customary instruments of credit policy, Discount policy and Open Market Operations, were wholly ineffective.‡ By the elimi-

* League of Nations: *World Economic Survey*, 1936-37, page 29.

† League of Nations: *Monetary Review*, 1937-38, page 18:--"In the last quarter of 1937, member banks reserve balances amounted, on an average, to about $7,000 million. Of this amount about $6,000 million were required reserves."

‡ *Federal Reserve Bulletin*, May 1937, page 377.

nation of this amount of excess reserves, 'the Federal Reserve System was brought into closer contact with the market and was placed in a position where sales or purchases in the open market could tighten or ease credit conditions in accordance with the public interest'.*

A *direct 'gold-sterilization'* scheme was initiated by the Treasury in December 1936. It was not connected at all with the Exchange Stabilization Fund. The gold purchases of the Treasury were financed by the sales of short-term Treasury bills to the money market. The gold purchased under this procedure was shown as "inactive gold" in the daily statement of the Treasury and amounted to nearly $1,200 million. It is interesting to note that the total amount of $14,512 million of gold was held by the United States at the end of 1938 which formed 58 per cent. of the world's visible gold reserves. This new method of offsetting was in essence the same as Sale-Open Market Operations of a Central Bank. But it was undertaken *outside* the Federal Reserve System, and was supposed to offer certain advantages of a technical and psychological nature, at the same time as the Treasury bore the interest costs. Had the normal Sale-Open Market Operations been undertaken by the Federal Reserve Banks, only a part of the inflow of gold could have been offset, as the Federal Reserve Banks' holdings of Government Securities were insufficient for this purpose.

It may be noted that during 1937 and 1938 the United States Government were taking measures with a view to combating the severe depression in industrial activity which had set in during the early autumn of 1937. Of these measures, there were some "principally designed to effect a *re-expansion of cash basis of the banking structure*. These, therefore, represented a complete reversal of the policy by which enormous contraction in the cash position had been brought about in the earlier years."† The first method was the 'de-sterilization' of $300 million of gold in September 1937. There was also the partial abandonment of the sterilization of current gold imports in February 1938. Besides, the reserve requirements of member banks which were raised in the past were reduced by 13¼ per cent. Ultimately, the policy of gold sterilization was discarded altogether, and the 'inactive

* League of Nations: *Monetary Review*, 1937-38, page 18.

† *Rederal Reserve Bulletin*, May 1937, page 377.

account ' in which the gold had been accumulated since December 1936, was liquidated.

The two types of Funds.—The short description of the two types of Funds given above may be briefed as follows : (i) The Exchange Equalization Account of the United Kingdom consisted in its initial stage mainly of assets in *domestic currency*, and as a consequence, it was capable of neutralizing the movements of short-term capital so as to prevent them from affecting the internal credit base. It was highly technical and was essentially a managed form of monetary standard.

The Exchange Stabilization Fund of the United States possessed in its initial stage, no assets in domestic currency but merely of *gold.* It was therefore powerless to prevent an expansion or contraction of Federal Reserve credit. Thus, when an inflow of short-term funds took place, the Fund could only obtain Dollars from the Federal Reserve Banks by selling gold certificates or gold to them ; but the purchases of new gold from the market with these Dollars increased the Federal Reserve cash available to the market. Similarly, in the case of an outflow of capital, the Fund was powerless in preventing a contraction of credit. The sales of gold by the Fund involved a transfer of balances at the Federal Reserve Banks from the ownership of the market to the ownership of the Stabilization Fund. The basis of the credit structure was thereby contracted, although no change occurred in the sight liabilities of the Federal Reserve Banks. The contraction could only be avoided if the Fund re-invested in the open market the Federal Reserve balances thus required.* Thus the structure of the Exchange Stabilization Fund did not permit it to offset the movement of short-term capital in the manner of the Exchange Equalization Account of Great Britain. It therefore necessitated the application of other methods to supplement the mechanism of the Exchange Stabilization Fund.

(ii) In the United Kingdom there was *no* fixed parity with gold, whereas in the United States the Dollar was a currency whose gold value was *fixed*, at least provisionally, at a definite point. As a consequence, the Exchange Equalization Account of the United Kingdom was free and powerful to make its operations more effective than the Exchange Stabilization Fund. The price at which the Exchange Equalization Account purchased or sold

* League of Nations: *Monetary Review*, 1937-38, page 19.

gold was wholly at the discretion of the Account, and was therefore, *penal* in its effect on speculative activities. This was, however, not the case with the Fund in the United States, which was, more or less, tied down to a definite gold price.

(iii) The ironing out of undue fluctuations in the exchanges due to erratic movements of foreign funds and thereby to safeguard internal economy was the aim of both these Funds, but in the case of the United States, the Exchange Stabilization Fund had for its primary purpose "the defence of the dollar against any general movement in the major currencies, sterling in particular, to levels that were not satisfactory to the United States."* The defence of the Dollar was against competitive exchange depreciation, and the Fund was established as an instrument for preventing the Dollar from rising in value in terms of other currencies.

(iv) Both these Funds conducted their operation in great *secrecy* which was forced on them because of the necessity of fighting speculative activities. However, the gold sterilization procedure in the United States could afford to publish its transactions as the gold price was already made public.

7. FUTURE OF 'RULES OF THE GAME' :—In the foregoing description we have touched upon the general features of the Funds, leaving aside their special technical working which is of considerable practical importance. The object was to show how out-of-place was the old machinery subject to the 'rules of the game.' When each country was desperately struggling to protect its domestic credit system from the disturbing influences of foreign countries, extraordinary machinery, such as the Stabilization Fund, had to be brought in to replace the 'rules of the game.' When the precepts of the Gold Standard ran counter to the requirements of domestic monetary stability, it was the latter that usually prevailed.† The real concern of a Government in those troublesome days was to maintain sound monetary stability at home, in order to obtain greater stability of national economy which was first being threatened by the great depression and by the insane movements of foreign funds.

The Funds have played an extremely useful part in those days of turmoil when abnormal movements of funds shook the internal

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* League of Nations: *International Currency Experience*, page 105.
† *Ibid.* page 144.

economies of various countries to their foundation. But the lesson is clear that the ' rules of the game ' were thoroughly ineffective in controlling monetary conditions in those abnormal days. Now that the War is over, the extent to which a renaissance of those ' rules of the game ' will prove appropriate and useful means for establishing a successful monetary policy, will depend on the willingness and ability of countries to co-operate in the *establishment of free movements of goods and of gold*. At least Bretton Woods has shown the way to establish international economic equilibrium by the establishment of the International Monetary Fund—a most advanced form of exchange machinery for the restoration of exchange stability. Unless time is given for this new world's Fund to work smoothly, it is difficult to predict the future of the ' rules of the game.' (Read Chapter XIII).

CHAPTER VIII

Indian Foreign Exchange and Exchange Control

A. MANAGEMENT OF THE STERLING EXCHANGE STANDARD.

1. THE STERLING EXCHANGE STANDARD :—For purposes of receiving and making foreign (overseas) payments, India has been for nearly five decades on the " Exchange " standard. Before 24th September 1931, it was the " Gold Exchange Standard " and the Rupee was linked to Pound Sovereign at the rate 1 Re. = 1*s*. 6*d*. (since 1926). After this date, however, when England went off the Gold Standard, India also shook off the gold link and the Rupee was linked to Pound Sterling (paper) and remains attached to it today at the rate 1 Re. = 1*s*. 6*d*.* In other words, £1 sterling is convertible without limit into nearly Rs. 13.3 and *vice versa*. But there have been two *limits* fixed to the fluctuations of the Rupee exchange rate :—

(i) the upper limit is 1*s*. $6\frac{3}{16}$*d*.
(ii) the lower limit is 1*s*. $5\frac{49}{64}$*d*.

2. GOVERNMENT OF INDIA WAS THE LARGEST DEALER IN FOREIGN EXCHANGE :—At this stage it is of the utmost importance to point out the characteristic feature of India's foreign exchange which distinguishes it from that of any other country in the world. This feature has arisen from the necessity of the Government of India to remit *annually* to the Secretary of State, what have been popularly known as the " Home Charges." The amount to be so remitted from India to London annually totalled nearly £35 million. These Home Charges consisted *mainly* of payments for the following :—(i) interest on loans contracted in England for the Indian railways and irrigation, (ii) the purchase of bar silver for Indian silver currency, (iii) stores purchased by the Government, (iv) pensions and furlough allowances to British and other officials who have served (or have been serving) in India, and (v) expenses of the High Commissioner's Office in London. In respect of this annual payment of nearly £35 million to London, the Government of India became the

* For the reasons for linking the Rupee to Sterling, read Chapter XXII.

largest single dealer and therefore *a dictator* in the Indian foreign exchange market. From the total Sterling that India obtained from her exports of merchandise to Great Britain, the Government of India appropriated annually £35 million sterling for their own purpose.

3. CONSIDERABLE REDUCTION IN "HOME CHARGES": This dictatorial position of the Government of India in the foreign exchange market of India has, however, almost vanished by March 31, 1946. The annual payment for the Home Charges could be substantially reduced if the Sterling loans borrowed for Indian railways and irrigation were to be paid off immediately, for these formed the heaviest part of the total charges. India's total Sterling Debt to Great Britain by the end of 1936-37 had amounted to £356.05 million. In 1937, when circumstances were favourable, a modest beginning was made towards repatriating this Sterling Debt. But the real opportunity came during World War II, when India became a creditor to Great Britain, instead of being the old debtor. By March 31, 1946, India had fulfilled the task of completely liquidating the Sterling Debt by mainly converting the Sterling loans into Rupee loans. (A detailed account of the Repatriation Schemes is given in Chapter X, to which reference is made).

With India's Sterling Debt wiped out and the country standing as a substantial creditor to Great Britain, the Home Charges have been considerably reduced. Some relatively minor items of payment, such as pensions, will hang on ; although to eliminate future payment on account of pensions, a scheme was under consideration for making *advance* provision in the form of a capital sum paid to Great Britain once and for all.

4. THE RESERVE BANK OF INDIA'S CONTROL OF FOREIGN EXCHANGE :—Since the establishment of the Reserve Bank of India, the foreign exchange is controlled by it. The Act has placed on the Bank the obligation to buy and sell sterling.

(i) THE BANK TO SELL STERLING :—The Bank shall sell, " to any person who makes a demand in that behalf at any of its offices and pays the purchase price in legal tender currency, sterling for *immediate delivery* in London, at a rate *not below* 1*s*. $5\frac{49}{64}$*d*. for a rupee." But no person is entitled to demand to buy Sterling less than £10,000.

(ii) OBLIGATION TO BUY STERLING :—The Bank shall buy, "from any person who makes a demand in that behalf at any of its offices, Sterling for immediate delivery in London, at a rate *not higher* than 1*s.* $6\frac{3}{16}$*d.* for a rupee." But no person is entitled to demand to sell an amount of Sterling less than £10,000.

At the same time no person shall be entitled to receive payment unless the Bank is satisfied that payment of the Sterling in London has been made.

(i) THE CONTROL OF THE LOWER LIMIT OF THE RUPEE'S EXCHANGE VALUE :—If by any factor or a combination of factors the Rupee's exchange value has the tendency to go *below* 1*s.* $5\frac{49}{64}$*d.*, the preventive or corrective mechanism would be to bring about *contraction* of Rupee currency. This contraction can be brought about in various ways :

(*a*) The Reserve Bank will *sell* Sterling to the public in the open market at the prescribed rate. When Sterling is sold by the Bank, the public pay the Bank in Rupees. Therefore Rupee currency gets contracted.

(*b*) If, however, it is found necessary, the Bank can *sell* gold to the public at stipulated rates. The effect of such sales would be the withdrawal of Rupee currency from circulation, that is, the effect would be deflationary.

(*c*) Further, when occasion requires, the Reserve Bank may try to enforce its Credit Policy on the money market. In this case, the traditional weapons can be used to bring about contraction of currency and credit. Thus, (i) the Bank rate will have to be *raised* to bring about contraction of credit and (ii) *Sale-Open* Market Operations will have to be undertaken to bring about contraction of currency and credit.

However, with the present organization of the Indian money market, it is not possible at all for the Bank to establish its Credit Policy, as was stated before. In any case, the machinery has been provided for.

(ii) THE CONTROL OF THE UPPER LIMIT OF THE RUPEE'S EXCHANGE VALUE :—In the opposite direction, if at any time the exchange rate has the tendency to go *above* 1*s.* $6\frac{3}{16}$*d.*, expansion of Rupee currency would have to be undertaken.

(*a*) The Reserve Bank would have to *purchase* Sterling from the public at the stipulated rate by inviting tenders from them. The Sterling so purchased would be paid for in Rupees, which would therefore result in expansion of Rupee currency. Incidentally, the purchasing of Sterling in India by the Reserve Bank of India is the method adopted for remitting the Home Charges.

(*b*) A supplementary measure would be to *purchase* gold from the public and pay for it in Rupees.

(*c*) Then, the Credit Policy of the Bank may have to be introduced, and in this case, it would be towards cheapening of credit : (i) The Bank rate would be *lowered* so that credit will be cheapened, leading thereby to expansion of credit, and (ii) *Purchase-Open Market Operations* will have to be undertaken, which would result in expansion of currency and credit. We have already made a mention, however, of the ineffectiveness of the Credit Policy under the present organization of the Indian money market.*

B. THE SYSTEM OF CONTROL OF EXCHANGE BEFORE ESTABLISHMENT OF RESERVE BANK OF INDIA.

1. SALES OF "COUNCIL BILLS" AND "REVERSE COUNCILS" :—Mention was made of the necessity on the part of the Government of India for remitting annually nearly £35 million from India to London to the Secretary of State to pay for the Home Charges.

(i) SALES OF "COUNCIL BILLS" :—Since India has had no gold currency and the payment for the Home Charges had to be made in *gold* in London, a system was evolved in order that this annual payment to the Secretary of State might not necessitate the actual buying of gold in India to be remitted to London. This system which existed *before* 1923, consisted in the *sales of "Council Bills" and Telegraphic Transfers by the Secretary of State for India in London.* The mechanism had the same effect as the sale of an ordinary bill of exchange. A simple example would make this clear.

Suppose X in England had bought goods worth £10,000 from Y in India. In the ordinary course X would either buy a bill of exchange through a broker or a bank and send it to his creditor Y or send actual gold to him. In either case Y would

* It is regretted that Arithmetic of Indian Foreign Exchange had to be omitted to bring the Volume to the size required by regulations of publication.

have to get the bill or gold exchanged *for Rupees*, the current coins of India. At the same time, suppose the Secretary of State for India had to receive £10,000 from the Government of India towards the payment of the Home Charges. The Secretary of State for India (the creditor) drew a bill called "Council Bill," (because it was drawn by the Secretary of State in Council) for £10,000 on the Government of India (his debtors) and sold it to X the debtor of Y, and like an ordinary banker or bill broker charged X for cost.

The Bill was an order asking the Government of India to pay to Y not £10,000 but the value of £10,000 *in terms of Rupees* at the then existing rate of *exchange*. When the Government of India paid Y in so many Rupees it was equivalent to paying their debt of £10,000 to the Secretary of State. In this manner the Government of India discharged their obligation and also helped the foreign importers of Indian commodities to make remittance to their creditors here.

If, however, as in the above example, X the debtor had to make *immediate* payment to Y, he would buy a *Telegraphic Transfer*, which was a Council Bill in a telegraphic form which cost more than the latter.

The allotment for Council Bills and Telegraphic Transfers was made to the highest bidder on Tuesday every week. But if they were demanded on other days of the week, "intermediate bills and transfers" were sold by the Secretary of State at a higher rate than that existing on the previous Tuesday.

When normal conditions prevailed, Council Bills were sold by the Secretary of State up to the limit of the Home Charges. *But if the supply of Sterling in India was greater than its demand,* its price was prevented from falling, *i.e. the rate of exchange was not allowed to rise above a certain point.* This was done by selling *extra* Council Bills in London. The effect was obvious. When the *extra* Bills were encashed at the Government of India Treasury, so many *more* Rupees were made to enter into circulation. That is, *expansion of currency* took place. *More Rupees than before were forced into circulation with the same number of commodities as before, with the result that the exchange value of the Rupee was artificially brought down.* Thus the upper limit of exchange was controlled.

(ii) SALES OF "REVERSE COUNCILS":—The counter-

part of the sale of Council Bills was the sale of "*Reverse Councils*" in *India* by the Government of India on the Secretary of State. These were bills sold in the *reverse* direction. When owing to the failure of the monsoon or some other adverse cause Indian exports fell off considerably and the balance of indebtedness went *against* India, *the demand for sterling would be greater than its supply* in India. In this case, the price of sterling was not allowed to rise, *i.e. the exchange value of the Rupee was not permitted to fall below the lower specie-point.* This was achieved by the sale, *in India,* of Sterling Bills or "Reverse Councils."

Suppose X in India had to remit £10,000 to Y in London and at the same time the Secretary of State wanted to transfer £10,000 to India. If in the ordinary course X could not buy bills on London in the open market, he would purchase "Reverse Councils" through an Exchange Bank worth £10,000 from the Government of India drawn in favour of his creditor Y and send it on to him. Y on his part would present it to the Secretary of State's Treasury and would receive Sterling worth £10,000. Thus, by the purchase of "Reverse Councils" the buyers in India paid in Rupees and made remittances in Sterling to London, and when the Secretary of State paid for them, it was equivalent to transferring the amount to India.

But when the Government of India sold "Reverse Councils", they were paid for by the buyers *in Rupees*. In this way Rupees were withdrawn from circulation and *contraction of currency* was effected and *the exchange value of the Rupee was accordingly* raised. By this mechanism the *lower* limit of exchange was controlled.

2. THE NEW SYSTEM OF MAKING GOVERNMENTAL REMITTANCES SINCE 1923 :—However, since 1923 this method of the sale of Council Bills (and Telegraphic Transfers) by the Secretary of State had been more or less abandoned and was substituted by the system of purchase of *Sterling in India,* sometimes by public tenders and at other times by private purchase. Since 1925 this new method had completely superseded the old.

The old method of sale of Council Bills was superseded for various reasons : In the first place, in this method the Exchange Banks first used to purchase Sterling Bills in India and had them

rediscounted in the London Money Market by their Head Offices, and with the amount so obtained they used to buy Council Bills and Telegraphic Transfers for their clients. This system was in practice found cumbrous and inconvenient to businessmen. Secondly, it will be shown in the course of this volume that on many occasions the Secretary of State sold Council Bills at such times and at such rates that the Indian Money Market was adversely affected. Thirdly, it always gave the Secretary of State undue power in the exchange market, which sometimes in practice subordinated the interests of the Indian Money Market to his own requirements.

The new method of purchase of Sterling in India has been better than its predecessor for various reasons :—

(1) It is in India that the export bills originate and it is in the same country that the liability of the Government of India to remit money also arises. It is, therefore, natural that the sellers and buyers of bills can best meet each other in the *same* country.

(2) Then, the factors which influence the immediate course of exchange can be judged more accurately and more promptly than in the old method. Besides, the purchases can be regulated according to the varying conditions of the Indian Exchange Market and the remittance operations can be conducted so as to avoid violent fluctuations in rates, and the consequent disturbances to the Money Market.

(3) Further, by this method the initiative in making remittances and thereby fulfilling their liabilities was rightly given to the Government of India who ought, in principle, to be able to remit the Home Charges smoothly and economically.

In 1935, the new system was handed over to the Reserve Bank of India for management of the Rupee Exchange.

C. EXCHANGE CONTROL SINCE SEPTEMBER 1939.

1. RESERVE BANK OF INDIA IN CHARGE OF EXCHANGE CONTROL :—The prime object of Exchange Control during war is to *conserve* and *completely mobilize* the country's foreign exchange resources. To achieve this object it is necessary to have complete control over (1) the purchase and sale of foreign exchange in any form, (2) exports and imports of commodities, (3) exports and imports of bullion and domestic foreign currencies,

and (4) foreign securities.

Consequent on the outbreak of the war the Governor-General promulgated the Defence of India Ordinance on 3rd September 1939* which with the Defence of India Rules delegated to the Reserve Bank of India the authority to administer the regulations to control foreign exchange. The statutory functions so delegated are being administered by a separate department of the Reserve Bank of India called the Exchange Control Department. The Governor of the Reserve Bank of India has assumed the functions of Controller. By a notification the Central Government (1) authorized the Reserve Bank of India to deal in foreign exchange and (2) empowered this Bank to authorize on its behalf other persons to deal in foreign exchange, gold coin and bullion.

2. THE FINANCIAL PROVISIONS :—The important financial provisions of the Defence of India Rules have been as follows :—

Rule 91 states *inter alia* that—

(1) No person resident in British India shall acquire any foreign exchange, or transfer rupees, gold coin or bullion, or securities with a view, directly or indirectly, to the acquisition of foreign exchange ;

(2) no person shall buy or borrow from, or sell or lend to, any person not authorized by the Reserve Bank of India in this behalf, any foreign exchange, gold coin or bullion.

The expression " foreign exchange " means (*a*) any currency other than currency which is legal tender in British India and Burma, (*b*) any bill or promissory note, payable otherwise than in Rupees, and (*c*) any credit or balance otherwise than in Rupees.

Acquisition by the Central Government of foreign exchange :—

Rule 92 specifies that every person who owns any such foreign exchange as may be specified in a Notification shall offer it or cause it to be offered, *for sale to* Reserve Bank of India on behalf of the Central Government at such price as the Government may from time to time fix.

This provision empowered the Central Government to acquire foreign exchange from any holder of it, if found necessary.

Restrictions on purchase and export of securities :—

Rule 93 states that no person shall acquire any securities from

* The Defence of India Ordinance was repealed with the coming into force of the Defence of India Act as from the 29th September 1939. It was also applied to Burma.

a person not resident in India or Burma except with the permission of the Reserve Bank of India. Persons resident in British India who have holdings of foreign securities or of foreign exchange in the form of foreign balances are therefore prohibited from making any transfers (by sale, mortgage, pledge, etc.) of any foreign securities, from acquiring further securities from a person not resident in India or from operating on any account held in a foreign currency except with the permission of the Reserve Bank of India.

N. B.—Foreign security means a security issued in any country other than India or Burma.

If any person contravenes the provisions of any of the above Rules 91, 92 and 93, he shall be punishable with imprisonment for a term, which may extend to five years, and shall also be liable to a fine.

Acquisition by the Central Government of foreign securities :—*Rule* 94 (3) states that the Central Government may, if it is of the opinion that it is expedient so to do for the purpose of strengthening its financial position, by order *transfer to itself any such foreign securities* as aforesaid specified in the order at a price so specified being a price which, in the opinion of the Central Government, is not less than the market value of the securities on the date of the order.

3. POLICY OF THE EXCHANGE CONTROL :—All dealings in foreign exchange were required to be transacted through authorized dealers, the Exchange Banks and certain Indian Joint-Stock Banks who were licensed as such. The policy of the Exchange Control was to ensure that all foreign exchange transactions in India were done on the basis of the rates quoted by the London Exchange Control combined with the Rupee rate for sterling, and authorized dealers in foreign exchange were informed that no business must be done by them outside these rates.

4. PURCHASE AND SALE OF FOREIGN CURRENCIES : The Rules regarding the purchase and sale of foreign currencies were applied to : (A) Sterling and other Empire currencies, (B) 'Hard Currencies' of 'Hard Countries', and (C) Non-Empire countries.

(A) STERLING AND OTHER EMPIRE COUNTRIES.—*No* restrictions have been placed on the purchase and sale of currencies of Empire countries with the exception of Canadian, Newfoundland and Hongkong Dollars. But transactions in Sterling have to take

place through authorized dealers, banks and public.

(B) 'HARD CURRENCIES'.—Restrictions have been placed on 'hard currencies' which meant that currencies which are based on gold or are linked to currencies which are linked on gold. Whereas, the following countries constituted 'hard currency countries':—

(1) All territories in or adjacent to the Continent of America with the exception of Canada, Newfoundland and any other part of His Majesty's dominions; the Argentine Republic and any dependency of the French Republic.
(2) The Philippine Islands and all territories under the sovereignty of the United States of America.
(3) Switzerland.

Restrictions on the above were absolutely necessary as possession of Dollars and Dollar Exchange during the war was all important for India and Great Britain.

(C) NON-EMPIRE CURRENCIES.—The purchase and sale of non-Empire currencies was controlled through banks and dealers, who were authorised to deal in foreign exchange. The transactions in these currencies were restricted to (1) genuine trade purposes, (2) other trade purposes such as payments of insurance premia, freight, ship's disbursements, commissions, pensions, etc., (3) travelling expenses, and (4) petty private remittances of a non-capital nature. The maximum limit of purchase and sale in each of these cases was fixed. The procedure prescribed in each case was minutely drawn up and was as thorough as it could be in order that the Reserve Bank of India may get complete evidence of each specific transaction. As regards remittances for capital purposes, the Reserve Bank of India's permission was necessary but "large transfers of capital nature will not normally be granted."

Sales of non-Empire currencies to any person, firm, bank or company resident *outside* India and Burma were not permitted. The Reserve Bank of India was prepared to purchase from authorized dealers the non-Empire currencies on the basis of the London Exchange buying rates for these currencies and the Reserve Bank of India's rate for Sterling less 1/8 per cent. commission, the payment being made in Rupees. The scheme was not applicable to Dollars which were not the proceeds of gold exports. The object of this scheme was to enable authorized dealers in foreign

exchange to cover immediately any large purchases they may have made of non-Empire currencies.

5. EXPORT CONTROL :—By a Notification dated the 9th March 1940 the Government of India instituted export control under the Chief Controller of Exports. Licence to export certain commodities to particular countries *outside the Sterling Area* was only to be granted provided a certificate was given by an authorised dealer in foreign exchange that the foreign exchange on the shipment has been or will be disposed of in a manner and within a period approved by the Reserve Bank of India. The scheme was meant mainly to control the foreign exchange proceeds of ' hard currency ' countries in accordance with the Empire Scheme formulated by the British Government. It originally applited to jute, jute manufactures and rubber, but was later applied to several other commodities.

(*a*) CONDITIONS GOVERNING EXPORT CERTIFICATES. The Notification stated that Export Certificates must only be issued provided :

(i) that the shipment is being invoiced in one of the listed currencies outside the Sterling Area and (*a*) that a bill is being drawn against the shipment of the *currency of country of destination,* which bill is being negotiated with or sent for collection through an authorised dealer in foreign exchange in India, or (*b*) that the payment has been or will be received by T. T. or draft in a listed currency, the exchange for which will be fixed by an authorised dealer in foreign exchange in India ; *or*

(ii) that the shipment is being invoiced in *Sterling,* and (*a*) that a Sterling bill is being drawn against the shipment under a credit opened by a London bank or accepting house and registered in the Bank of England, and which carried with it certain undertaking as to its liquidity. or (*b*) that the payment has been or will be received by means of a Sterling or Rupee T. T. or draft, *or*

(iii) that the shipment is being invoiced in *Rupees* and that payment has been or will be received in Rupees which have been obtained by a sale to an authorised dealer in foreign exchange in India of one of the listed non-Empire currencies on the basis of the London Control rates for the particular country.

Later, exports to countries outside the Sterling Area (with the

exception of Arabia, Iran, Afghanistan and Tibet) were only permitted by the Notification of 31st May 1941, provided (i) that the shipper made a declaration at the time of the shipment as to the method employed of financing ; and (ii) that the name of the bank through whom payment for the goods had been or was to be received, was stated. The shipping documents in all cases were to be forwarded to the foreign importer through a bank authorised to deal in foreign exchange. Further, payments for exports could only be made by certain approved methods which varied according to the classification of the importing country. This classification was made by the Bank of England which had instituted a system of Registered Accounts for banks in the United States of America and Switzerland and of Special Payment Accounts for banks in certain other countries with whom it had concluded Payment Agreements.

(*b*) METHODS OF EXPORT FINANCE :—The exports to non-Sterling Area countries were financed, as mentioned above, (i) by bills drawn or remittances received in currency of the country of destination ; (ii) by bills drawn or remittances received in Rupees ; (iii) by bills drawn on London ; and (iv) by bills drawn in Sterling on the country of destination.

The bulk of exports from India to the countries outside the Sterling Area was financed under *bank credits*, and generally, foreign exchange payments were regularly received within the stipulated period of six months. As regards :—

(i) THE 'HARD CURRENCY' COUNTRIES.—In this group the United States of America remained practically the sole country in point of exports during the last two years of the war, and nearly 84 per cent. of the goods shipped to this country was financed by bills drawn in U. S. Dollars (in 1945). Besides, the proportion of goods financed by this method compared to those financed in Rupees or Sterling bills on London remained approximately the same during these years.

(ii) OTHER FOREIGN COUNTRIES.—Canada and Newfoundland were the countries with whom Special Payment Agreements were concluded. Trade with Canada was almost entirely financed by Sterling bills on London, although the fourth method was also occasionally utilized. Shipments to South American countries were financed entirely in Sterling. Whereas, exports financed in Rupees comprised shipments to Portuguese East Africa

from India.

It may, however, be stated that since more than 85 per cent. of the total exports were taken over for war purposes by the British Government, Dominion Governments and the United States of America on the Lend-Lease method, Export Control was mainly concentrated in the hands of the Government and was therefore considerably simplified, as the largest payer for exports was the Government.

6. IMPORT CONTROL :—A system of Import Control was introduced by the Government of India by a Notification on 20th May 1940. Import Control was placed in charge of the Chief Controller of Imports. Under the system, no sale of foreign exchange in payment of imports from outside the Sterling Area was permitted unless the importer was in possession of an import licence certifying that he is authorised to purchase exchange. As allocation of foreign exchange was automatically made to holders of import licences, such allocation was determined by the Government of India and not by the Reserve Bank of India.

The main object of Import Control is to control foreign exchange. Government, therefore, imposed control on the import of nearly 94 per cent. of luxuries. The object was to make people spend as little as possible on luxuries imported specially from 'hard currency' countries, so that 'hard currencies' could be reserved for purchasing essential war materials.

The luxuries were divided into two categories : (i) those completely prohibited from 'hard currency' countries, and (ii) those whose imports were regulated on a "quota" basis. When the United States of America entered the war the situation changed completely. Imports from that country were automatically and drastically cut down and 'priority' was given to certain importers for such commodities which were absolutely necessary for India. But from the time the United States of America started giving goods on the Lend-Lease system, the necessity for control of Dollar Exchange was considerably reduced, as the importers in India merely paid the Government of India directly in Rupees and *no transaction in foreign exchange took place.* Further, the deterioration in the shipping situation after the entry of Japan into the war made the supply of shipping space an overriding consideration in the issue of licences.

But with the war nearing its end; the quotas under the Import

Licensing System for the import of consumer goods from countries outside the Sterling Area were increased as a means (1) of combating inflation, and (2) of meeting the extreme shortages arising from the severe restrictions placed on imports during the first four years of the war. Greater facilities were also granted for journeys to countries outside the Sterling Area, particularly to the United States of America, for business and study purposes. When the majority of European countries were liberated, trade in trickles was resumed between these countries and India on Government account, but arrangements were also made for private financial transactions to a limited extent with these countries.

However, the administration of Import Control did not seem to have worked satisfactorily. Protests were frequently voiced by businessmen, firms and the press against the administration's 'muddles.' The *Times of India* in the course of an Editorial on 18th July 1945 on "More Import Muddles" voiced the feelings of the business public as follows : "The administration of this Control has never been efficient and today it has practically no excuse for existence. The fact that it has become a vested interest for its own officials cannot be denied, and there is ample evidence to prove that it is seriously handicapping economic recovery. This remark applies not only to the system of import controls but to many of the other bureaucratic hurdles which such control has brought in its train."

CHAPTER IX

India a Member of the Sterling Area Group

As soon as England was pushed off the Gold Standard in September 1931, several countries also threw off the Gold Standard and linked their currencies to paper Sterling.* These countries formed a wide area of exchange stability known as the Sterling Area. The countries which formed the Sterling Area were prominently the following :—

(1) The British Commonwealth of Nations, with the important exception of Canada, whose currency took a middle course with the Pound and the Dollar of the United States of America.

(2) Some non-British countries comprising Portugal, Denmark, Norway, Sweden, Esthonia, Latvia, Finland, Egypt, Thailand, Palestine and Japan.

1. THE PRESSURE ON NATIONAL CURRENCIES :—The suspension of the Gold Standard by these countries was primarily influenced by the depreciation of Sterling, although their balance of payments had deteriorated and had already overstrained their currencies. The pressure on the currencies since the beginning of 1929 was due principally to the *heavy decline in the value of their staple exports* consequent on a continuous and heavy fall in prices. To a lesser extent it was due to the cessation of capital inflow, a diminution of income from services and investments abroad and the fact that import values declined less rapidly than export values.

There also existed a second group of factors by which balance of payments was also adversely affected in other counties, such as withdrawals of foreign balances as a result of a widespread liquidity crisis and the flight of domestic capital (to which we have referred in a previous chapter). A third group of factors consisted of such monetary and budgetary measures undertaken by countries "as would raise the general level of internal prices and costs or prevent their reduction relatively to those ruling abroad, and thereby not only make it impossible for the balance of payments to readjust itself to the extent required for the

* Read Chapter XXII for the factors which threw England off gold.

maintenance of the exchange rates, but induce an outflow of foreign balances and a flight of domestic capital."*

2. HOW THE PRESSURE ON CURRENCIES WAS MET : It is important to note that the pressure on the exchanges which developed at different stages of the great depression was met by nations in various ways : (1) As stated above, many countries went off the Gold Standard and pegged their currencies to paper Sterling. These formed the Sterling Area. (2) Others leadered by Germany imposed Exchange Control by which a more or less complete monopoly of exchange transactions was placed in the hands of a public body. (3) With France at their head, a few countries struggled to maintain the full Gold Standard by a policy of 'Consistent Deflation' for nearly five years after 1931 but had eventually to *devalue* the currency or to go off gold. These were known as the Gold Bloc countries. (4) Finally, the United States Dollar constituted a group by itself. The abandonment of the Gold Standard in April 1933 by this country was followed nine months later by provisional stabilisation of the Dollar in terms of gold at about 59 per cent. of the former parity, while power was vested with the President to devalue the Dollar down to 30 per cent. of its former parity at his own discretion.

3. THE CRITERIA APPLIED TO STERLING AREA COUNTRIES :—Two main criteria which could be applied to the Sterling Group are as follows :—First, these countries maintained their currencies in a fixed exchange relationship with the Pound Sterling. Secondly, a country may be considered to belong to this Group if its central monetary authority usually kept the bulk of its foreign assets in the form of Sterling balances and other liquid assets in the United Kingdom. The second criterion is to some extent a natural consequence of the first.

In some cases, as in India, Australia and Egypt, Central Banks were required by statutes to hold *only sterling* in their foreign exchange reserves. But in all other cases, for reasons of safety and convenience, Central Banks were inclined to hold their foreign balances in a currency which did not fluctuate in terms of their own monetary unit of account.† So long as the value of Sterling did not differ from that of the gold Pound, it made

* League of Nations: *Monetary Review*, 1936-37, page 9.

† *Ibid.*, 1938-39, page 12.

no difference whether the standard in England was the Gold Standard or the Sterling (Paper) Standard. But when the Pound depreciated in September 1931, with prospects of further depreciation, it made all the difference to other countries whether to continue to link their currencies to gold or link them to depreciated Sterling. It may be noted that many countries normally on the Gold Standard were already in practice on Sterling before the fall of the former. "The system was not new. Merged in the general Gold Standard regime it had not been conspicuous in form."*

4. THE STERLING AREA GROUPS :—The Sterling Area countries may be grouped as follows :—

(i) those that immediately depreciated their currencies in company with the Pound, like India, Egypt and Portugal ;

(ii) those that held on to the old parity for a time before depreciating at one stroke to the level of the Pound, like Esthonia and Latvia ;

(iii) those that left the Gold Standard very soon after Sterling but fluctuated for some time more or less independently, before being linked to the Pound, like a few non-British countries such as Denmark, Norway, Sweden, Finland, Greece and Japan ;

(iv) those that had already departed from the Gold Standard before 1931, like Australia, New Zealand and Argentine.

5. THE CRITERIA'S SIGNIFICANCE TO THE UNITED KINGDOM :—These two characteristics of the Sterling Area Group were of very great significance to the United Kingdom. The first meant that no downward adjustment of the Pound Sterling could be effected without an equivalent reduction in a large number of countries. As regards the maintenance of foreign exchange reserves in the United Kingdom, although the Central Banks did not show in their returns in which currencies they held their foreign balances, it is reasonable to assume that they must be to a considerable extent in Sterling. The aggregate central exchange reserves of fifteen important countries of the Sterling Area reached their peak in September 1937, which was £261.7 million. Of this amount India's share was £69.8 million, the largest portion of the total. But thereafter a decline occurred chiefly due to two factors : (i) Almost all of these countries,

* League of Nations : *International Currency Experience*, page 46.

with the exception of Sweden, depended for their foreign exchange supplies on the export of primary commodities. The fall in the prices of these commodities, which began in 1937, placed a strain on their balance of payments.* This strain was witnessed in a reduction in their foreign exchange reserves rather than in their gold stocks. Most countries, including India, had adopted the practice of keeping their gold reserve unchanged, while allowing their foreign funds to fluctuate in conformity with a change in the balance of payments. (ii) Besides, in 1938 there was a tendency on the part of certain countries like Norway, Sweden, Ireland and Latvia to convert a part of their foreign exchange reserves into gold.

It may, however, be noted that although the greater part of the increase in total reserves in the Sterling Area countries between 1932 and 1937 took place in foreign exchange, yet the fact that gold in the reserves also increased, shows that there was no absolute economy of gold through pooling in the reserve centre.† The following Table D illustrates this fact :—

TABLE D

CENTRAL RESERVES OF 15 STERLING AREA COUNTRIES ‡

£ (000,000's)

In £	1929	1931	1932	1933	1934	1935	1936	1937	1938
Exchange	150.9	82.4	108.7	167.8	208.7	211.1	221.6	253.6	216.1
Gold	97.5	139.3	150.7	161.1	186.0	200.9	215.6	208.4	250.1

The Table D shows an almost continuous increase in gold reserves, but a major part of this increase was due to two countries, Sweden and the Union of South Africa. However, it tends to prove that the expected economy of gold was not obtained.

6. FACTORS WHICH INDUCED COUNTRIES TO JOIN THE STERLING LINK :—There were many factors which

* League of Nations: *Monetary Review*, 1938-39, page 14.
† League of Nations: *International Currency Experience*, page 55.
‡ Abstracted from League of Nations: *International Currency Experience*, page 55.

induced these countries to link their currencies to Sterling. Of these, the most formidable was the fact that most of these countries had very important economic relations with the United Kingdom which they could not afford to shed off. The Table D1 illustrates the relative importance of the United Kingdom in the *external* trade of the important countries coming within the Sterling Area.

TABLE D 1

Percentage share of the United Kingdom in the Foreign Trade of important countries

COUNTRY	EXPORTS			IMPORTS		
	1929	1933	1937	1929	1933	1937
I. Some British Empire Countries:						
1. Australia ...	45	54	52	41	42	42
2. New Zealand ...	74	86	76	49	51	50
3. Union of South Africa	66	78	79	43	50	43
4. India ...	21	30	32	42	41	32
II. Some Non-British Countries:						
1. Denmark ...	56	64	53	15	28	38
2. Norway ...	27	20	25	21	23	18
3. Sweden ...	25	26	23	17	18	12
4. Finland ...	38	46	43	13	41	32

As the figures in the above Table D1 indicate, a substantial part of the export trade of most of these countries was with the United Kingdom and it was therefore to their own interest to allow their currencies to depreciate with the Pound in order to be able to keep up their export-prices as well as the volume of exports to the United Kingdom. If any one of these countries had failed to depreciate its currency in conformity with the Pound, it would have lost its export market with the chief trading partner the United Kingdom, in competition with others. This was a vital consideration. The above Table shows that

the percentages shown under 'exports' were in almost all cases higher than shown under 'imports'. Further, the Ottawa Agreements introduced Imperial Preference in 1932 and knit closer the commercial relations of the countries forming the British Commonwealth of Nations. The result of these Agreements is shown in the above Table which illustrates the growing percentage of exports to the United Kingdom from the Empire countries. The United Kingdom had also concluded with non-British countries such as the Scandinavian countries, special trade agreements to the benefit of both parties.

To India, in particular, the Sterling link was economically very necessary at the time. Since India's external trade with countries which were expected to join the Sterling link was nearly 75 per cent. of her total external trade, it was imperative that, if these markets were not to be lost to her, the country's currency should be linked to Sterling. Considering India's sea-borne trade with the British Empire countries alone, it would be found that it formed a very substantial part of it, as is made clear by Table D2.

TABLE D 2

Direction of India's Sea-borne Trade. Percentage to total trade

	1928		1930		1938	
	Imports	Exports	Imports	Exports	Imports	Exports
1. Total British Empire Countries ...	59.4	57.3	58.7	54.6	57.3	52.7
2. United Kingdom alone	33.6	35.7	32.2	40.3	31.4	34.1

With more than half of India's total sea-borne trade with the British Empire countries and more than three-fourths with all the Sterling Area countries, it was wise to have linked the Rupee to Sterling. It was some anchor to which the Rupee could be linked in order to obtain the advantage of maintaining stable exchange so necessary for maintaining such a large proportion of the country's external trade, particularly at a time when the great depression had taken root. Besides, stability of exchange

has been an important factor as regards India because of the country's obligation to remit annually the Home Charges to England, although since the repatriation of almost the whole of India's Sterling debt to England such a necessity is not so urgent. But, apart from the obvious advantage of maintaining stable exchange with the United Kingdom, the only possible method of safeguarding India's trading position in competition with other countries was to *depreciate* the Rupee in unison with the Pound Sterling.

At this time it was suggested by some that the Rupee should not have followed Sterling and that it should have been allowed 'to find its own level'. If this suggestion had been followed, in the absence of any link whatsoever, the exchange value of the Rupee would have faced such rapid and violent fluctuations that India's external trade would have been chaotic and India would have lost her export markets. Further, if the Rupee had been kept on gold, instead of being anchored to depreciated Sterling, it would have *appreciated* in terms of Sterling, since Sterling had depreciated nearly 30 per cent. in terms of gold. The consequence would have been a lowering of the general level of prices in India and this would have added to the calamity already produced by low prices in the country. In short, the effects would have been *deflationary* and would have harmed still further India's production, business and trade.*

Another important factor which led the various countries to form the Sterling Area was the fact that "the decline of money income and business activity in the great depression was less severe in the United Kingdom than in the other leading industrial nations."† Even before the United Kingdom went off gold, industrial production in 1930 was at 92 per cent. of the 1929 level in the country, compared with 83 per cent. in the United States of America and 86 per cent. in the world as a whole (excluding the U.S.S.R.). The following Table D3 shows the extent of industrial production in the three major industrial countries in the world.

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* For further reasons reference is made to Chapter XXII.

† League of Nations: *International Currency Experience*, page 49.

TABLE D 3

INDUSTRIAL PRODUCTION

YEAR	UNITED KINGDOM	UNITED STATES OF AMERICA	GERMANY
1929	100	100	100
1930	92	83	88
1931	84	68	72
1932	**83**	**53**	**58**
1933	88	63	65

The above indices worked out by the Economic, Finance and Transit Department of the League of Nations show that even when the great depression had reached its lowest level in 1932, industrial production in the United Kingdom was only 17 per cent. below the 1929 level, whereas in the United States of America it was 47 per cent. and in Germany 42 per cent. below that level. This bore testimony to the relatively greater intrinsic economic strength of the United Kingdom and also to the more effective measures undertaken towards recovery in this country. This was one of the reasons why certain countries chose to peg their currencies to the currency of a country which could offer relatively the greatest economic stability, for then alone could they expect to obtain stability of the exchange values of their own currencies.

Further, agricultural countries, depending mainly on agricultural produce for their exports had much to gain by linking their currencies to Sterling for the United Kingdom's imports consisted to a considerable extent of foodstuffs, and these countries could not afford to throw away their trade with this country (U. K.), which was of substantial help in feeding their large agricultural population. Besides, as the fall in the prices of primary commodities had already imposed a severe pressure upon the balance of payments of agricultural debtor countries, the pegging of their currencies to depreciated Sterling would have the effect of preventing prices of primary commodities from falling

lower, and in the near future, to raise these prices.

7. STABILITY OF EXCHANGE RATES :—The countries comprising the Sterling Area had succeeded in their object of obtaining stability of exchange rates to a considerable extent during the years that followed the linking of their currencies to Sterling. It may be observed that the Gold Standard did not exist and therefore there was no question of considering the cost of shipment of gold nor did the gold export and gold import points exist within which the exchanges were left free to fluctuate. The Sterling Area countries had *not* maintained exchange stability by maintaining a fixed price of gold, while permitting the exchange rates to fluctuate within the gold points. So even the small fluctuations which were thus possible under the Gold Standard were eliminated in the mutual exchange relationships within the Sterling Area, as the fixity was not with gold but directly with the paper currencies of the countries.* It was, therefore, obvious that the mutual stability of exchanges in the Sterling Area was, as long as it existed, absolute.

From the eleborate statistics compiled in the *Monetary Review* of the League of Nations, 1938-39, two important conclusions could be deduced :—

(1) That in the case of countries like India, the percentage of gold parity moved *extremely closely* with that of Sterling. Thus the variation of percentage of parity was between the highest .6 and lowest .1 during the years 1931 to 1938.

(2) That the range of fluctuations in the gold value of various Sterling Area currencies on the whole was very narrow.

8. THE EMPIRE DOLLAR POOL :—All the countries belonging to the Sterling Area were pooling their foreign exchange resources during World War II. Supplies of Dollars accruing from exports to the United States, or from the expenditure of U. S. A. troops, were transferred to the Central Fund in London, and were then allocated to various uses and to various members of the Sterling Area, ' in the proportions considered most beneficial from the standpoint of the total war effort '.† The foreign balances which the Sterling Area acquired during the war were

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* 'Similarly under an exchange-reserve system costs of transport do not arise and the spread between buying and selling rates can be narrowed to cover merely the Central Bank's administrative costs of book-keeping, etc."—League of Nations: *International Currency Experience*, page 52.

† League of Nations: *World Economic Survey*, 1942-44, page 194.

thus all held in *Sterling*. The Dollar Pool was in effect, stated Sir Archibald Rowlands, the Finance Member, "the modification imposed by war conditions of the Sterling Area arrangement which existed for nearly a century. Under such an arrangement Empire and other countries found it convenient and economical to settle their transactions on international account through Sterling. Before the war Sterling was freely convertible into any other currency. With the restricted ability of the Commonwealth to earn foreign exchange as a result of the war and with imports necessary for the prosecution of the war being high, the different countries in the Commonwealth pooled their resources and met from the Pool their essential requirements of hard currencies."* It was beyond all question that in the time of war a pooling arrangement and a rationing of Dollars were necessary in order to utilize the Dollars available to the best advantage of war and essential civil requirements of the Sterling Area countries. London, therefore, became the natural pooling centre and the Dollar Pool was nothing but a continuation of the pre-war Central Empire Reserve Pool in London which was for decades the Clearing House for all Sterling Area countries.

During World War II, for *security reasons*, it was not possible to disclose the volume and details of transactions of the Dollar Pool. Sir Archibald Rowlands, the Finance Member, in his Budget speech, said that it was difficult to arrive at completely accurate figures but with the help of the Reserve Bank of India he was able to deduce that *the balance in India's favour* was Rs. 49.23 crores as at March 1945. In his opinion "the most that could be claimed by India would be a *pro rata* share of the existing pool assets."

As stated previously the curtain was to fall under the Anglo-American Loan Agreement, when the Empire Dollar Pool would automatically be dissolved within one year of the commencement of the Agreement. Now that the Agreement has actually been signed in August 1946 the end of the Pool is near. The latest figures regarding India's position *vis-a-vis* the Dollar Pool were given by Mr. Manu Subedar, M.L.A. (Central). He stated that according to the latest figures given to him by the Government of India, a total amount of Rs. 453,00,00,000 had accrued to

* Budget Speech on 28th February 1946.

India, while a total sum of Rs. 339,00,00,000 had been used by the country, leaving a balance of Rs. 114,00,00,000 by March 31, 1946.*

* In his address to the Commerce Graduates' Association, 9th August 1946.

CHAPTER X

Repatriation of India's Sterling Debt

1. INDIA'S STERLING DEBT :—India's total Sterling debt by the end of 1936-37 amounted to £356.05 million. It consisted, as stated before, *mainly* of (1) Loans contracted in England for Indian Railways and Irrigation and Ports, (2) the purchase of Bar Silver for Indian Rupee currency, and (3) various Stores purchased by the Government of India during all these years.

The annual remittance from India towards the liquidation of this debt (including interest on loans) amounted to, as stated previously, nearly £35 million and formed a permanent thorn on the side of the Indian budget. In this annual payment was included the payment for Sterling Pensions and Furlough Allowances of those Britishers and others who had been servants in India and expenses of the High Commissioner's office in London. These annual payments have been known as " Home Charges " and formed a nightmare of every Finance Member. The desirability of repatriating this enormous Sterling debt in order to free India of this yoke was all the time before the Government. With the establishment of the Reserve Bank of India, the Government of India found in it an ideal banking machinery in order to undertake the repatriating operations effectively and without disturbing the exchange market of India. A modest beginning in this direction was made in 1937. But the one powerful factor, which should help the Reserve Bank of India in fulfilling this mission, was that India's visible balance of trade should be increasingly in favour of India in order to enable the Bank to make sufficient purchase of Sterling which could be accumulated and paid to England. That opportunity presented itself very favourably at the outbreak of World War II.

2. ACQUISITION AND DISPOSAL OF STERLING ASSETS :—Generally, the net accretion of Sterling assets in India during the war had resulted from (1) the favourable balance of payments on private account, and (2) the increasing expenditure incurred in India on account of the United Kingdom for war disbursements and also incurred by the latter on account of

other Allied Governments and recoverable from the British Government (to which reference is already made). The following Table E shows the manner of acquisition of Sterling in India during the period September 1939 to March 1940 and compares it with the period September 1939 to March 1945.

TABLE E

ACQUISITION OF STERLING *

Period: September 1939 to March 1945

Total amount (in crores of Rupees)

Source	September 1939 to March 1940	September 1939 to March 1945
1 Sterling Assets held by the Reserve Bank ...	64	64
2 Sterling purchased by the Reserve Bank ...	86	644
3 Sterling payments made by His Majesty's Government	16	1,292
Total amount of Sterling available for disposal and disposed	166	2,000

The Table E shows enormous increase in the acquisition of Sterling from Rs. 166 crores by the end of March 1940 to Rs. 2,000 crores by the end of March 1945. As mentioned previously, the payments in Sterling made by His Majesty's Government during the last three years would have increased still further, but for the official sales of gold in India, which was a method adopted for meeting a part of the Allied war expenditure in the country. With the closure of the war the payments on this account were bound to decrease in amount. With the shipping position becoming more favourable, imports of commodities would naturally increase. As a result the accumulations of Sterling were expected to be slowed down in the future.

* Abstracted from Reserve Bank of India: *Report on Currency and Finance*, 1944-45, page 38.

It is equally important to take account of the disposal of the total Sterling acquired. The Table E1 below compares the amounts disposed of during the two periods, September 1939 to March 1940 and September 1939 to March 1945.

TABLE E1

DISPOSAL OF ACQUIRED STERLING

Total amount (in crores of Rupees)

MANNER OF DISPOSAL	September 1939 to March 1940	September 1939 to March 1945
(a) Amount of Sterling utilized for Repatriation Schemes ...	22	411
(b) Other Sterling commitments (derived figures) ...	2	226
(c) Sterling holdings of the Reserve Bank at the end of the period ...	142	1,363

The Table E1 shows that at the end of March 1945 Sterling valued at Rs. 411 crores was repatriated as against Rs. 22 crores at the end of March 1940. More significant is the total Sterling holdings of the Reserve Bank at the end of March 1945 which stood at Rs. 1,363 (or £1,022 million) as against Rs. 142 crores at the end of March 1940. Item (*b*) "other Sterling commitments" needs an explanation. It is a derived figure being the total Sterling receipts minus Sterling holdings of the Bank and the Sterling amount utilized for repatriation schemes. This figure in recent years has comprised such items as transfers to the Secretary of State and the High Commissioner of India and Burma on account of Home Charges, etc., and remittances to meet the cost of overseas purchases on Government account.*

TOTAL NET ACQUISITION OF STERLING :—The total *net* acquisition of Sterling may be deduced by adding together the

* The Reserve Bank of India: *Report on Currency and Finance*, page 39. This report does not give details for various items included in 'Other Sterling Commitments.' No comment is, therefore, possible.

Sterling purchased in India by the Reserve Bank and the Sterling paid by His Majesty's Government, and then deducting from this total the "other Sterling Commitments." Thus at the end of March 1945 the net acquisition of Sterling stood at Rs. 1,710 crores as against 100 crores at the end of March 1940.

3. STERLING DEBT REPATRIATION SCHEMES SINCE 1937-38 :—As stated previously, a beginning in the direction of Repatriation of Sterling debt was made in 1937, but it had to be temporarily discontinued owing to the slackening of Indian trade. The repatriation was undertaken vigorously from 1939 onwards when the Reserve Bank of India was authorised to purchase *non-terminable* Indian Sterling loans in the *open market* as and when they were available and transfer them to the Government for cancellation. In their place additional Rupee non-terminable loans were created upto the same nominal value in accordance with the requirements of the market. This Repatriation was (i) voluntary, (ii) related to non-terminable Sterling loans, and (iii) was made by purchases in the open market.

In 1940-41 a great change was introduced in the scheme of Repatriation. It established for the first time (i) *compulsory* conversion in place of voluntary conversion and was applied to (ii) *terminable* loans. Holders of these loans were asked to sell them to the British Treasury at the price ruling at the close of business on 7th February 1941. The British Treasury would then hand them over to the Indian Government at the same price for cancellation. The Rupee counterparts were to be issued by the Indian Government up to the same value. Under this scheme Sterling loans worth £60.05 million were cancelled.

In 1941-42 Repatriation was made by (i) open market purchases to the value of £12.11 million, and (ii) by two compulsory schemes to the value of £86.93 million. Then followed the most fruitful year for Repatriation, 1942-43. During this year the total Repatriation aggregated to £119 million. Of this total amount, the largest amount was *Redemption* of 3½ per cent. Sterling stock (1931 and after) to the value of £56.21 million ; the next was *Funding* of Railway annuities of the value of £27.06 million and Repatriation of Railway debentures of the value of £18.58 million. The remaining amount was repatriated under the compulsory scheme and open purchase system.

The virtual completion of the schemes of Repatriation took place in 1943-44 when £20.9 million was repatriated and the remaining £0.41 million was repaid in 1944-45.

The Table E2 below shows the progress of Repatriation year by year of Terminable and Non-terminable Loans as well as Railway debentures and Railway annuities—all in Rupee value.

TABLE E 2

STERLING DEBT REPATRIATED SINCE 1937-38

(In crores of Rupees)

YEAR	LOANS			RAILWAY DEBENTURES	GRAND TOTAL (a+b+c)
	Terminable (a)	Non-terminable (b)	Total (a+b)	(c)	(d)
1937–38	2.87	1.12	3.90		3.99
1939–40	10.34	12.45	22.79		22.79
1940–41	86.24	8.81	95.05		95.05
1941–42	18.16	113.89	132.05		132.05
1942–43	1.93	93.32	95.25	27.35	158.68*
1943–44	.21	1.37	1.58	15.77	17.35
1944–45	.12	.38	.50	.5	.55
Total Face Value	119.87	231.34	351.12	43.17	430.46

4. MANNER AND RESULTS OF DISPOSAL OF REPATRIATED STERLING DEBT :—It is also necessary to take account of the manner of disposal of repatriated Sterling debt during the seven years. It should show (i) the extent of the *conversion* of Sterling debt into Rupee debt, and (ii) the amount of reduction in the total debt. These points have been made clear in the following Table E3 :—

* The amount includes Rs. 36.6 crores of the capital portion of the Railway annuities funded on 1st October 1942.

TABLE E 3

MANNER AND RESULTS OF REPATRIATED STERLING DEBT

(In crores of Rupees)

During Period	Amount Repatriated A		Rupee Counterparts created B	Additions to Rupee Debt (Permanent Debt); Holdings of Rupee Counterparts C	Reduction in Debt D		
	Face Value	Market Value			Debt cancelled on Repatriation D1	Rupee Counter-parts cancelled D2	TOTAL (D1+D2)
1937-38 to 1944-45	430.46	428.91	277.09	242.01*	140.89	50.08	191.97

* This amount includes Rs. 15 crores of special issue in connection with the funding of the Railway annuities. This is the reason why there a discrepancy between figures in B and C.

The Table E3 shows (i) that the total amount of Rupee-counterparts created in lieu of the Sterling loans repaid was Rs. 277.09 crores. But of these, Rs. 50.08 crores, that is, 18 per cent. were cancelled (D2), while the remaining were held as investments jointly by the public, the Reserve Bank and the Government; the respective amounts at the end of 1944-45 being Rs. 200.05, Rs. 24.21 crores and Rs. 2.75 crores. The total of 240.1 includes in addition Rs. 15 crores of special issue for funding Railway annuities; (ii) that against Rs. 430.46 crores of Sterling debt repatriated, additions made to the permanent Rupee debt by the end of 1944-45 were Rs. 242.01 crores, that is, nearly 56 per cent., while *cancellation totalled Rs.* 191.97 *crores or* 44 *per cent.*

5. THE VALUE OF THE REPATRIATION :—The period 1937-45 will remain a landmark in the economic and political history of India. By the Repatriation of Sterling, India has wiped out, particularly in a brief spell of almost three years, accumulations over decades of its public indebtedness to the United Kingdom. A foreign debt valued at £356.05 has been extinguished at the cost of Rs. 428.91 crores. But of this cost, the permanent Rupee debt created has been Rs. 242.01 crores, *and the remaining national debt amounting to Rs.* 191.97 *crores is washed off.* This is the picture of the Balance Sheet of India's Sterling debt with the United Kingdom over decades. Undoubtedly, World War II came to the rescue of India as the greatest extinguisher of Sterling debt, but it speaks volumes for the craftsmanship of the Reserve Bank of India to have fulfilled this great economic mission during the troubled times of the war with the least disturbance to the money market. To the annual Indian Budget this " pay off " will give a great relief, as the annual remittances for payments due to the United Kingdom are considerably reduced. A decade ago, the annual payments for interest charges alone amounted to £13 million, which exist no more today.

The Repatriation has strengthened India's financial structure and enhanced India's credit in the world. But apart from improving considerably India's credit structure, the conversion of external debt in part into internal debt and considerable reduction of the annual Sterling payments to Great Britain, were bound to diminish the strain upon the foreign exchanges of India and strengthen the Rupee's external value. The new position

may be epitomized in the words of a prominent Indian broker who while emphasizing India's future foreign exchange position said, "In future the Rupee will rule over Sterling, not Sterling over the Rupee."

The only normal liability which remains on account of which Sterling remittances will be necessary is the annual payments for Sterling pensions, provident funds and furlough allowances. It is estimated that these payments will not exceed £6 million a year. The Government of India have had under consideration a scheme for making advance provision for the requisite Sterling remittances wherewith to meet future payments in respect of these liabilities on the lines of the arrangements made for Sterling Railway Annuities. This would mean handing over to the United Kingdom a capital sum which when invested would bring in interest £6 million a year. As these charges would on Indianization of services, naturally decline in amount in the future, the arrangement might be described as a "purchase of a tapering annuity." Since this capital sum could easily be set aside from the Sterling balances which stand to the credit of India, its transaction would not involve the issue of fresh Rupee currency. Of course, ultimately to liquidate this item, the Rupee currency will have to be provided for in the annual budgets of the Central and Provincial Governments, so that the scheme would be self-liquidating. If this scheme materializes India will write her political advancement on a *clean sheet*.

The extinction of India's external public debt places her in the position from a debtor to a creditor. This creditor position is bound to have profound influence on the course and character of India's external trade in the future. In this connection H. E. the Viceroy said, "When it is remembered that India's export trade in the past rested largely upon the necessity of making remittances for the service of her overseas debt, that henceforth, not only will this factor be absent ; but on the contrary, India will have to accommodate an excess of imports in order to receive payments due to her, it will be realised that the change which has occurred is one of the deepest significance."*

The Repatriation leaves behind it the ownership of the railways and other valuable productive enterprises as the national property

* In course of his address to the Central Legislature, 2nd April 1943.

of India. When it is remembered that the enormous surplus profits from the railways alone, and which accounted for Rs. 36.51 crores in 1945-46, instead of leaving the country will remain wholly to swell the finances of India, the Rupee debt created against Sterling debt could be wiped out in a few years and substantial contributions would be made to General Revenues for the economic development of India. Assuming that this future annual surplus revenue remains at Rs. 30 crores and that half of this surplus were devoted towards the liquidation of the Rupee debt of nearly Rs. 242 crores, this debt could be entirely liquidated within 15 years. Further, the *entire Public debt* of India by the end of March 1945 stood at nearly Rs. 1,600 crores. If 3 per cent. is the average rate of interest to be paid on this sum, the surplus revenue from the railways alone can cover the total annual interest charge if the surplus revenue reached the figure Rs. 50.84 of 1943-44. Such are the prospects which should reveal advantageously an impressive record of intelligent public finance.

When it is remembered that India has not repudiated nor scaled down her Sterling debt but has paid in *cash* every Pound Sterling on her debt to Great Britain, she can face the world as an honest country which does not live on an 'overdraft.'

CHAPTER XI

The Sterling Balances

(A) FOREIGN EXCHANGE RESERVES OF STERLING AREA COUNTRIES :—The foreign exchange reserves of Sterling Area countries increased by leaps and bounds during World War II, as is shown in Table F below. It should be noted that the Table does not include all the members of the Sterling Area, for the figures of some countries have not been made available. Nor does it contain the holdings of commercial banks in most cases. The Indian Exchange Banks, (Foreign Banks), for example, are known to have held considerable amount of Sterling, but the figures have not been disclosed.*

TABLE F

FOREIGN EXCHANGE RESERVES OF STERLING AREA COUNTRIES †

£ (000,000's)

	1938	1939	1940	1941	1942	1943	1944
Grand Total ...	235	320	440	625	835	1,250	1,600
India alone ...	46	85	142	217	357	642	935

Although, as stated above, the figures of all Sterling Area countries have not been included, on the basis of 1938 figures it appears that before the war all the Sterling Area countries held between £250 million and £300 million in London. Even if the last and the highest figure of £300 million is taken as the basis, the exchange reserves increased more than five times.

The stock of Sterling held by the Reserve Bank of India has been the largest and accounted for more than 50 per cent. of

* League of Nations: *World Economic Survey*, 1942-44, page 196.

† The countries included are: Australia, Egypt, Eire, Iceland, India, Iraq, Malaya, New Zealand, Palestine, Union of South Africa and West and East Africa. The data regarding the non-British Empire countries which were neutrals, like Sweden and Portugal, do not specify the details regarding Sterling exchange.

the total holding of Sterling Area countries in 1944.* As already stated, this Indian holding of Sterling would have been far more than this figure but for two facts :

(i) By the end of 1944, India had repatriated almost the whole of her Sterling debt to Great Britain, amounting to £356.05 million.

(ii) The United Kingdom and the United States of America officially sold gold in the Indian market and which began in the middle of 1943.

However, as the Reserve Bank of India has been accumulating a part of its exchange reserve in the form of Dollars of the United States since February 1944, it would not be correct to estimate from this date the total of India's Sterling Balances by converting the whole of the Reserve Bank's foreign exchange assets into Sterling.

When Great Britain made enormous purchases of Indian commodities required or made other disbursements in connection with the prosecution of the war, the Reserve Bank of India financed them in India by making payments in Rupee-paper currency, and in exchange for it, Sterling Balances were created in London in favour of India and were invested in British Treasury bills. In this way arose the Sterling Balances which served, in fact, as *legal cover* for the increasing domestic note issues. However, the exchange reserves of most Sterling Area countries, including India, increased far in excess of what was required by law for supporting the note issues.

These Sterling Balances formed, in fact, a short-term advance to the United Kingdom. In addition, the Repatriation of India's long-term Sterling debt to Great Britain was a substantial financial assistance to the latter country. In these two ways, India along with other Sterling Area countries, had provided a substantial proportion of the external financing which had played so important a part in the United Kingdom's war effort and which was technically known as "dis-investment abroad" and which aggregated £3,073 million.† The contribution made by the

* Abstracted from the official compilation in the League of Nations: *Money and Banking*, 1942-44.

† League of Nations: *World Economic Survey*, 1941-42, page 40. Further, "Needless to say, the external dis-investment has made possible not only an increase in imports but also a diversion of export industries to domestic war production. The Lancashire cotton industry, one of the leading export industries in the past, may be mentioned as an example. Exports of cotton manufactures were greatly restricted and in March 1942 they were prohibited altogether."

Sterling Area countries to the war effort of the United Kingdom would thus be reflected in part in the increase in their Sterling Balances.

India has redeemed her capital obligations to Great Britain completely and has therefore become Britain's creditor. It is now Great Britain's turn to redeem her obligations to India. The best way in which Great Britain can meet her debt is by *exports*. Exports have always been " the heart-beats " of Britain's economic existence. Before the war, Great Britain devoted a larger proportion of her resources to export trade than any other country in the world. But, even so, in 1938 the value of her exports was rather under 10 per cent. of her total national income. Indeed, Great Britain must take time to restore her exports to the pre-war level. There will be an inevitable time-lag that must elapse when a country has to turn over from war to peace production. Destroyed houses and destroyed household goods have first to be restored. A nation half-starved and diseased during the agony of six war years, must be well fed, well clad and well nursed to restore her to the desired efficiency. Capital goods will have to be manufactured first to restore her domestic factories. Industrial workers who had to become soldiers will have to be re-trained in industrial technique, on their return to their original jobs. Reconversion must take up a good deal of time. At the same time Great Britain will have to speed up her exports for they will enable her to pay for the foodstuffs and raw-materials absolutely necessary for her existence.

India's most pressing requirements are for capital goods—plant and machinery for replacing exhausted and obsolete machinery in present industries, as well as those required for new industries, which she has planned to institute ; electrical machinery, agricultural machinery, locomotives, motor coaches, etc. Imports of this order into India are indispensable for creating secondary industries on a vast scale in the future. To Great Britain the exports of these capital goods are greatly indispensable, for their exports are the best providers of foreign exchange. From this point of view, the more advanced is India's industrialization and the quicker it is brought into existence, the sooner will Great Britain be enabled to develop her export industries.

There is another and more fundamental reason why India's

industrial progress will be a helpful factor rather than a disadvantageous factor for Great Britain as an exporter. It is best to express it in the words of Mr. Hargreaves Parkinson, Editor, *The Financial Times*, London. He states :

> " It is a universal rule that the volume of imports a country is able and willing to buy, per head of its population, is a fraction of its own standard of living . . . the level of subsistence of many of India's million of men and women has not only been one of dire poverty, but the efforts seriously to raise it have been frustrated by the tendency for increases in the total of India's national wealth not to be reflected in a higher standard of nutrition, housing and amenities of life but to be absorbed by increases in the numbers of her population. The only way, it may be, of breaking out of the circle of what economists used to call ' the iron law ' lies in increasing the national income more rapidly than a predominantly agricultural system, frequently practised in a poor and rudimentary way, can ever hope to achieve. Ultimately, on that ground alone, if on no other, the efforts of those in India who press for an industrial plan on the largest scale, may have complete economic justification. The conclusion, therefore, must be that no responsible outside commentator should regard India's plans in that direction as anything but highly desirable in her interests."

If by rapid industrialization of India, the standard of living of the masses is substantially raised and with it the national income, Great Britain will find in India an ever-increasing market for her exports. It is in Great Britain's own interests to give assistance to Indian planners in raising the standard of living of the people.

The effect of the existence of these Balances on Great Britain will be that a certain proportion of British exports will have to be canalized in a narrow direction. In short, the Balances will be a stimulant to British trade in India, and as Mr. Hargreaves Parkinson states,* ' a super-charging factor, which, in turn, may induce India to take a large quantum of imports from Great Britain than she would otherwise, because, by so doing, she will reduce the total burden falling on her annual balance of payments '. However, the immediate problem for Great Britain is to produce goods, not to find customers. The war-ravaged countries call for help in all kinds of goods and particularly in

* *Commerce*: Indo-British Economic Relations Supplement, December 1945.

capital equipment for reconstructing all that is destroyed. In this connection, Mr. H. A. Marquand, M.P., Secretary to the Department of Overseas Trade, stated,

> "For the next year or two, a world which has been starved of supplies will be very ready to take the goods which we shall be turning out in ever-increasing quantities. Shortages of demand for our export is not one of the problems which we shall have to face during the immediate future. Our manufacturers may even have an embarrassing choice of alternative markets. Where this is so, I am confident that they will give preference to customers with whom they have done business in the past, and from whom they expect to continue to receive orders when the period of shortage is over. I am equally convinced that, since their aim will be to have satisfied permanent customers, they will not be tempted to exploit scarcity conditions by charging unreasonable prices for goods in short supply. This does not mean that the prices of our goods will necessarily be the same as before the war. Prices have risen during the war because of increased material, labour and other costs, and they are unlikely to fall at all rapidly during the next few years either in the United Kingdom or in other industrial countries."

(B) THE BRETTON WOODS CONFERENCE AND TREATMENT OF THE STERLING BALANCES :—The United Nations Monetary and Financial Conference met at Bretton Woods, New Hampshire (U.S.A.), in July 1944, and adopted agreements for the establishment of an International Monetary Fund and the International Bank for Reconstruction and Development. Details of the Conference and of these institutions are given in Chapter XIII. At this Conference, India was represented by an Indian Delegation which consisted of (1) Sir Jeremy Raisman, the Finance Member (Leader), (2) Sir Chintaman Deshmukh, Governor of the Reserve Bank of India, (3) Sir Theodore Gregory, Economic Adviser to the Government of India, and two non-officials, (4) Sir R. K. Shanmukham Chetty, and (5) Mr. A. D. Shroff, Director of Tata Industries Ltd. Mr. B. K. Madan acted as the Secretary.

The Indian Delegation laid great stress upon the inclusion of abnormal war balances in the purview of the International Monetary Fund. They tabled suitable amendments to achieve

the object, which, however, were not accepted by the Conference.

1. FIRST ATTEMPT TO INCLUDE ABNORMAL WAR DEBTS :—The first amendment proposed was to include in the purposes of the Fund " to promote and facilitate the settlement of abnormal indebtedness arising out of the war."

Sir Jeremy Raisman, in his statement before Committee I on the 5th July, observed that the importance attached to this question in India was so great that it determined largely the public interest in, and attitude towards, the international monetary proposals. That, India expected to embark, after the war, on a programme of considerable industrial development and looked to the availability of her large Sterling Balances for the import of capital equipment in the immediate post-war years when the United Kingdom would be largely engaged in internal rehabilitation and reconstruction. If the problem was too large to be tackled fully by the Fund, the Fund should, nevertheless, provide some partial assistance towards its solution.

The amendment was objected to on the following grounds :—

(i) The delegate of the United States stated that the Fund had already to do as much as any human institution could undertake and to ask it to do more would strain its resources beyond capacity ; that the problem of war-time indebtedness was too big a problem in itself to be dealt with by the Fund ; and that the operations of the Fund would be " water-logged " if the large question of the liquidation of war indebtedness were to be dealt with through its machinery.

(ii) The delegate of the United Kingdom stated that this question was primarily one for settlement between the creditor and the debtor.

2. SUPPORT TO EGYPT'S SIMILAR AMENDMENT :—However, the question came up again in the meeting of Committee I on the 7th July when the Egyptian Delegation placed an amendment to the Purposes of the Fund which was to be " to assist a multilateral clearing of accumulated war balances."

Mr. A. D. Shroff, on behalf of the Indian Delegation, supported the Egyptian amendment and pleaded most strongly for the conversion at least of a *portion* of India's Sterling Balances into other foreign currencies. In course of his very able speech, he said :

"Dr. Goldenweiser, the delegate from the United States of America, mentioned that this item (of war balances) was excluded from the Joint Statement on the ground that it would unduly overload the Fund. I presume he said this on the understanding that perhaps at the very outset of the Fund the entire amount of these foreign credit balances would be taken over by the Fund in one lump sum. This is not the case. We plead for the assistance of the Fund spread over a period of years to secure multilateral convertibility of at least a portion of our foreign balances. I say this because with the long-standing relationship between India and the United Kingdom and traditional commercial ties between the two countries, I take it that a large portion of our Sterling Balances will ultimately be utilised in obtaining capital goods from the United Kingdom. I appreciate and very greatly sympathise with the difficulties of the United Kingdom now and in the early post-war period owing to the unfortunate loss of valuable foreign investments and, due to other difficulties, it is not likely that the United Kingdom will be in a position to reach a stage of free convertibility for Sterling at an early date. On the other hand, our country is pulsating with hopes and aspirations of large-scale industrial development to raise the standard of living of four hundred millions of our population. We cannot, therefore, be asked to wait indefinitely till the United Kingdom has reached a stage when Sterling would be freely convertible into other currencies. *We therefore want conversion at least of a portion of our balances into other foreign currencies.*"*

The amendment suffered the same fate as its predecessor but the essence of the discussion was conveyed to Commission I.

3. THIRD ATTEMPT TO INCLUDE REASONABLE PROPORTION OF STERLING BALANCES :—The Indian Delegation, however, placed a revised amendment before Commission I, with a view to avoiding any possible misunderstanding of their approach towards the question of multilateral convertibility of the Sterling Balances through the Fund. The revised amendment was as follows : "To facilitate the multilateral settlement of a reasonable portion of the foreign credit balances accumulated amongst the member countries during the war so as to promote the purposes referred to in sub-division 2, without placing undue strain on the resources of the Fund." Once again Mr. A. D.

* Appendix to the Report of the Indian Delegation, page 42.

Shroff in his very lucid speech explained that the Delegation realized that a very large portion of the Sterling Balances must be liquidated through direct exports from the United Kingdom, but pointed out that the capacity of the United Kingdom to supply India's requirements of consumer and capital goods would be extremely limited during the immediate post-war years and it would assist the process of India's industrial development, and thereby the flow of international trade, if a reasonable portion of the Sterling Balances could be converted into other currencies after the war. He also replied to the argument of the delegate of the United States that the inclusion of the war balances would overload the Fund. He said :

> "My answer to the delegation of the United States is that you will not unduly overload the Fund if you create machinery for multilateral convertibility for a reasonable portion of these accumulated balances. The resources available to the Fund for tackling the problem are in my judgment inadequate and look rather like sending a jellyfish to tackle a whale. What I ask for is a *multilateral settlement of a portion of our balances*. If the Conference is prepared to accept the principle of our amendment, then I see no difficulty in evolving a concrete formula by which the two purposes set out in our amendment can be met. The purposes set out in our amendment are two : To secure multilateral convertibility for a reasonable portion of our balances and, secondly, to devise a formula so as not to place undue strain on the resources of Fund."*

The delegate of the United States, however, reiterated the reasons for their opposition to the proposal and was followed by Lord Keynes, Head of the United Kingdom Delegation, who made a statement on behalf of his Delegation, setting forth clearly that the settlement of these debts must be a matter between those directly concerned and that they did not intend to ask assistance in the matter from the Fund, which was not meant to deal directly with war indebtedness.

LORD KEYNES GIVES ASSURANCE :—Although the amendment was rejected, Sir Shanmukham Chetty and Mr. A. D. Shroff stated on their return to Bombay, that the Indian Delegation were able to persuade Lord Keynes to make a categorical statement that "under no circumstances will there be any

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* Appendix to the Report of the Indian Delegation, page 48.

repudiation of these debts by the British Government."* Lord Keynes, in course of his statement on behalf of the Delegation of the United Kingdom at the meeting of Commission I, on July 10, 1944, said, " We appreciate the moderate, friendly and realistic statement of the problem which Mr. Shroff has put before you today. Nevertheless the settlement of these debts must be, in our clear and settled judgment, a matter between those directly concerned. When the end is reached and we can see our way into the daylight we shall take it up without any delay, *to settle honourably what was honourably* and generously given."† (Read Chapter XIII.)

(C) THE ANGLO-AMERICAN LOAN AGREEMENT (DECEMBER 1945) AND PROVISIONS FOR THE STERLING EXCHANGE AGREEMENTS :—A further development concerning the question of liquidation of the Sterling Balances took place in December 1945, when the Anglo-American Loan Agreement was signed. A review of the important provisions of this Agreement is necessary.

1. *Line of credit.*—Under this Agreement the Government of the United States will extend to the Government of the United Kingdom a line of credit of dollars 3,750,000,000 (or £1,000 million) which may be drawn upon at any time between the effective date of this Agreement and 31st December 1951, inclusive. Besides, dollars 600,000,000 are granted to settle up for Lend-Lease goods.

2. *The purpose of the line of credit.*—The purpose of the line of credit is :—

(i) to facilitate purchases by the United Kingdom of goods and services in the United States ;

(ii) to assist the United Kingdom to meet transitional post-war deficits and its current balances of payments ;

(iii) to help the United Kingdom to maintain adequate reserves of gold and dollars ;

(iv) and to assist the United Kingdom to assume the obligations of multilateral trade as defined in this and other Agreements.

* In the interview they gave to the representative of the *Times of India*.

† Annexe to the Report of the Indian Delegation, page 44. Sir Shanmukham Chetty and Mr. A. D. Shroff, in the interview they gave to the *Times of India*, stated : " Our contention was that to leave such a huge balance (India's Sterling Balance) outside the scope of the Fund would very largely defeat the object of the Fund by forcibly creating bilateral arrangements which it was the purpose of the Fund to avoid."

3. *Line of Credit and other obligations.*—

(*a*) It is understood that any amounts acquired to discharge obligations of the United Kingdom to third parties outstanding on the effective date of this Agreement will be found from resources *other than* this line of credit.

(*b*) The amount of the line of credit drawn by 31st December 1951, shall be repaid in 50 *annual instalments* beginning on 31st December 1951, with interest at the rate of 2 per cent. per annum.

(*c*) Waiver of interest will not be requested in any year, unless the aggregate of the releases or payments in that year of Sterling Balances accumulated to the credit of overseas Governments, Monetary Authorities and Banks (except in the case of Colonial Dependencies) before the effective date of this Agreement is reduced proportionately, and unless interest payments due in that year or loans referred to above are waived.

The proportionate reduction of the releases or payment of Sterling Balances shall be calculated in relation to the aggregate released and paid in the most recent year in which the waiver was not requested.

It is to be clearly understood from provision 3(*a*) of the Agreement that *no* part of the amount of the Loan could be utilized by the United Kingdom towards discharging its obligation to third parties, so that there was no question of liquidating the accumulated Sterling Balances by means of even a part of this Loan. Further, clause 3(*c*) of the Agreement states that a waiver of interest will be granted to the United Kingdom only if the Sterling Balances were reduced proportionately during that year.

4. *Sterling Area Exchange Agreements.*—The Agreement contains positive provisions regarding agreements that the United Kingdom should make with the Sterling Area countries concerning Sterling Exchange. These provisions relate to (I) the Sterling receipt from *current* transactions of all Sterling Area countries and (II) the *accumulated* Sterling Balances.

(I) *As regards Sterling Receipts from current Transactions.*—With regard to current Sterling transactions the Agreement provides as follows :

(1) " The Government of the United Kingdom will complete agreements as early as practicable and, in any case not later than one year after the effective date of this Agreement, unless, in exceptional cases, a later date is agreed upon after consultation under which, immediately after the completion of such arrangements, the Sterling receipts from *current* transactions of *all*

Sterling Area countries (apart from any receipts arising out of military expenditure by the Government of the United Kingdom prior to 31st December 1948, to the extent to which they are treated by Agreement with the countries concerned on the same basis as the balances accumulated during the war), *will be freely available for current transactions in any currency area without discrimination* with the result that any discrimination arising from the so called Sterling Area Dollar Pool will be entirely removed and that each member of the Sterling Area will have its current Sterling and dollar receipts and its free disposition for current transactions anywhere."

The Agreement also provides that "the Government of the United Kingdom agrees that it will not apply exchange controls in such a manner as to restrict the use of Sterling Balances to the credit of residents of the United States arising out of current transactions."

(II) *As regards Accumulated Sterling Balances.*—With regard to the arrangements concerning the accumulated Sterling Balances, it is again necessary in view of the importance of the subject to give the text of the Agreement which provides as follows :—

(1) "The Government of the United Kingdom intends to make arrangements with the countries concerned varying according to the circumstances of each case for an early settlement covering the Sterling Balances accumulated by Sterling Area and other countries prior to such settlement (together with future receipts arising out of *military* expenditure by the Government of the United Kingdom to the extent to which they are treated on the same basis by Agreement with the countries concerned)."

"The settlement with the Sterling Area countries will be on the basis of dividing these accumulated balances into three categories :

(*a*) balances to be released at once and convertible into any currency for current transactions ;

(*b*) balances to be similarly released by instalments over a period of years beginning in 1951 ; and

(*c*) *balances to be adjusted as a contribution to the settlements of war and post-war indebtedness*, and in recognition of the benefits which the countries concerned might be expected to gain from such a settlement. The Government of the United Kingdom will make every endeavour to secure the early completion of these arrangements."

(2) "In consideration of the fact that an important purpose of the present line of credit is to promote the development of multilateral trade and facilitate its early resumption on a non-

discriminatory basis, the Government of the United Kingdom agrees that any Sterling Balances released or otherwise available for current payments will, *not later than one year* after the effective date of this Agreement, unless, in special cases, a later date is agreed upon after consultation, be freely available for current transactions in any currency area without discrimination."

IMPLICATION REGARDING SCALING DOWN OF STERLING BALANCES :—It was but natural that the Indian reaction to the Anglo-American Loan Agreement should be extremely unfavourable. It merely enunciated the general principles for clearing Sterling Balances. The freeing of the proceeds of current transactions, [see (*a*) above] was, of course, the first stage. Then it provided [in clause (*b*) above] vaguely that a proportion of the accumulated balances were to be made immediately available for exchange purposes, followed by annual instalments starting in 1951. No mention was made regarding the exact proportion or the actual minimum amount which should be made available. But clause (*c*) was the most disquieting feature of the Agreement. This item, concerning " balances to be adjusted as a contribution to the settlement of war and post-war indebtedness ", contained the possibility of some degree of scaling down of the balances—a proposal which was thoroughly unjust to India which bore the sacrifice of making colossal payments for full six years on behalf of the United Kingdom in her days of peril for her military and essential civil requirements.

(D) POST-WAR ADDITIONS TO INDIA'S STERLING BALANCES :—It was expected that with the closure of World War II, additions to the Sterling Balances of India would cease or diminish substantially, as there would be no necessity for making large purchases in India of materials for military purposes on the part of the United Kingdom or for other disbursements connected with the war within the country. But, since August 1945, the Sterling Balances increased from Rs. 1,488,54 lakhs to Rs. 1,724,70 on 10th May 1946, an increase of Rs. 236,16 lakhs since V.-J. Day.

In the House of Commons, Mr. Peter Freeman (Labour) asked the Chancellor of the Exchequer, Dr. Hugh Dalton, on 26th February 1946, if he would state the weekly increase in Sterling Balances accumulated by the Reserve Bank of India since V.-J. Day, whether this increase had been accompanied by or was due to inflationary tendencies in India, whether Britain profited

by the increase of these Sterling Balances, and in view of India's poverty and the prospect of famine whether this accumulation of Sterling Balances will now have ceased altogether. Dr. Dalton replied : "The average weekly increase for the last 19 weeks of 1945 was £7,000,000 and for the first 7 weeks of 1946, £2,000,000. Most of these increases represent repayments to India for expenditure on Indian forces outside India. Such expenditure is no more inflationary than any other Government expenditure. It certainly does not impoverish the people of India nor add to the danger of famine." Such a reply was bound to create misgivings in India regarding the Sterling Balances. If the increase in the Sterling Balances were to proceed uninterruptedly even in peace time at the will of Great Britain, it would be nothing short of forcing India to give a line of credit to her without any agreement and without India's consent.

(E) APPREHENSION ABOUT STERLING BALANCES :— We have already referred to the suggestion implicit in the Anglo-American Loan Agreement regarding the scaling down of India's Sterling Balances. Far from any approach on the part of the United Kingdom for a settlement of India's Sterling Balances, many British statesmen and some of the British Press made suggestions for scaling down these Balances. In support of this suggestion, the common arguments brought forward were briefly the following :—

(1) That the Sterling Balances were not commercial debts. The best reply to such an argument was given by Mr. Manu Subedar (Congress), a Member of the Central Legislative Assembly. He stated, "I agree they are not commercial debts. They stand on a very much higher level. The goods represented by the Sterling Balances were taken from this country at controlled prices, goods which were very badly required by the people of the country (India). They were taken by the use of political power and without our consent."* Whether a debt incurred is commercial or otherwise, is a debtor morally justified in pleading that a part of the debt should be written off because he had not borrowed the amount for 'commercial' uses ? At the same time, no law is so unkind as to compel a creditor to extend credit merely for commercial uses. And in the case of

* In his speech before the Central Legislative Assembly on March 1, 1946, when debate took place on the Interim Report of the Bretton Woods Committee of the House.

the Sterling Balances the credit was virtually created by the debtor. Professor Edward Thompson rightly stated : "We owe India money because for military necessity we took from her goods she assuredly could not and would not have given us freely. We are bound to repay this debt fully."*

(2) Another argument adduced in favour of scaling down of the Balances was that as a result of inflation, 'India accumulated more Sterling as prices rose higher.'

Many facts emerge from the creation of the Sterling Balances :

(i) When Government of India made purchases of materials on behalf of the British Government, they did so in the capacity of a monopolist. There was an all-pervading *quantitative* control placed by the Government over the commodities needed by them, to the extent that civilian population was made to starve of them for full six years. Thus, the production of cotton cloth, manufactured jute, manganese, coal, mica, cement and of several other commodities was entirely in the grip of the Government. There was no chance of any leakage because the supplies were controlled at the very source of production. Quantitative control was further tightened by Government who imposed on certain producers, for instance of cloth and jute, the exact qualities that could be produced by them. It is but natural that if Government had both quantitative and qualitative control in the form of a levy over the essential commodities required by them, it is the Government who should be the dictator of prices. No choice was left to the seller to bargain for his price.

(ii) Similarly, when huge disbursements were undertaken by the Government for war purposes, they were made at prices fixed by them. For example, when contracts were given away in India by Government, for the construction of works such as aerodromes, roads and barracks, the prices set were by the Government. If *the prices fixed were in such cases unusually* 'inflated', the main reasons were (1) the acute shortage of labour, (2) great difficulties of transporting materials and men to the centres of construction, and above all (3) the quickness of time necessitated by war conditions, during which certain works had to be completed. In fact, *speed* in the execution of works was the one most important compelling force that made the Government offer better prices

* Writing in the *New Statesman and Nation*, October 1945.

to contractors, who, later, found themselves unprepared for such emergencies and were therefore compelled to spend far larger sums for mobilization of men and materials over long distances.

(iii) Further, food prices rose *far higher* than those of non-food articles which Government had purchased and these led to widespread distress and misery among the Indian population. Necessarily, therefore, higher wages had to be paid to workmen whether in factories or on construction work. And let it be stressed with the greatest emphasis that the higher wages paid to workmen did not by any means lead to a rise in their standard of living. Far from that, the people were starved of many essentials of necessaries (including articles of food during the first three years of the war) because the Government had continuously pooled them for the successful execution of the war. The privations borne during the war by millions of Indian population already steeped in poverty far outweigh the pecuniary gains that were placed in the pockets of a few manufacturers and contractors. The Sterling Balances have left behind them a record of India's untold sacrifices.

(iv) The British Parliamentary Select Committee on National Expenditure acknowledged India's attempts at price control and even incautiously expressed the opinion that the prices paid were fair.* According to the White Paper embodying their report, *fair prices* had on the whole been secured by the authorities for war stores and for food bought in India. Comparative figures in India and the United Kingdom for a very wide range of stores including textiles, general stores, and munitions indicated that "*Indian prices were seldom higher and were generally appreciably below the United Kingdom prices.*" The bulk of military orders both for India and the United Kingdom were negotiated at contract prices as against Indian commercial prices ; these "war contract prices", particularly in the case of steel, which represented 50 per cent. of the Indian Supply Department's expenditure, were *appreciably below* the British and United States prices. Prices in respect of cloth were also *appreciably below* market levels, the maximum rise in these being 100 per cent. during the first half of 1943 as against the record increase of over 400 per cent. for civil supplies.† Here

* *The Financial Times* wrote in connection with the subject of settlement of Sterling Balances, 25th January 1946.

† Reserve Bank of India: Report on Currency and Finance, 1944-45, page 22.

is proof of the reasonableness of the prices charged. It would be more correct to state that Great Britain fixed certain prices for her purchases in India rather than that India charged such prices. *The Financial Times* wrote in this connection :

> " India's special case illustrates two of the chief factors in the settlement of Sterling Balances : Firstly, relative price movements. Secondly, contribution to Allied war effort related to local population's standard of living. India's case is very difficult in equity, besides politics. India is a poor country, which nevertheless managed to service her debt to Britain when India was debtor. On equal sacrifice principle, India would be entitled to improve her capital position in compensation for her war effort, but on the same principle such compensation would not be expected from Britain. So, no bilateral bargain can be completely fair to both sides. Moreover, it was only India's difficult position which induced Britain to make such grotesquely generous financial arrangements in 1940. Shirking any attempt at adjustment on the same grounds would mean endowing anti-British sentiment."*

(F) THE CENTRAL LEGISLATIVE ASSEMBLY DEMANDS SETTLEMENT OF STERLING BALANCES :—Yet another pronouncement was made regarding the settlement of the Sterling Balances by Great Britain and it was from Dr. Hugh Dalton, the Chancellor of the Exchequer, who in reply to a question in the House of Commons said : " The Sterling Area countries are to be approached to seek voluntary agreements with each of these countries concerned for the adjustment of the total of the Balances, in consideration of the origin of these Balances and of the common interest of the Sterling Area countries and ourselves in arriving at a ***realistic basis*** for our future international trade transactions."†

Grave misgivings were voiced in the Central Legislative Assembly owing to certain speeches by eminent men in England advocating the *scaling down* of Sterling Balances and the earliest opportunity was taken when the question of India's adherence to Bretton Woods Agreement came up before the Assembly on January 29, 1946. The Assembly unanimously agreed to a Congress Party motion to appoint a Committee of nine members

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* *The Financial Times* wrote in connection with the subject of the Sterling Balances, 25th January 1946.

† Reported in the *Commerce*, December 1945.

to go into the question of India's adherence to the final act of the Bretton Woods Conference.*

The Committee presented the Interim Report to the Central Legislative Assembly on February 26, 1946. In the first place, the Report endorsed the statement made by the Finance Member that India was not bound in any way by the terms of the Anglo-American Loan Agreement of December 1945.

Secondly, the Report goes on to state, "in our view the final decision whether it would be to India's advantage to remain a member of the Bretton Woods institutions may be determined to a very considerable extent by the outcome of the negotiations, which His Majesty's Government are committed to undertake with the Government of India on the subject of liquidation of the Sterling credits. If these negotiations are unduly delayed, it may be necessary for India to withdraw before these negotiations take place, because it may happen that India will be called upon under the agreement to undertake commitments, which she may feel unable to shoulder in the absence of a satisfactory solution of the Sterling credits. Similarly, it may be necessary for India to withdraw from the International Monetary Fund and the International Bank in case the proposals of His Majesty's Government for the settlement of the Sterling Balances are not satisfactory to India."

Thirdly, "Apprehensions in this regard were voiced in the course of discussions in the Committee, owing to certain speeches by eminent men in England advocating the scaling down of Sterling Balances, and *we are assured in this connection by the Finance Member that nothing has happened, since the authoritative pronouncement made by Lord Keynes,* Head of the United Kingdom Delegation at the Bretton Woods Monetary Conference,† in response to the demand of the Indian Delegation for an assurance on the subject, *to diminish in any manner the authority or force of that statement.* Nevertheless, in order to allay the anxieties which have been caused by certain statements in Parliament and in the British press, we would welcome an early and authoritative reassurance by His Majesty's Government on this point and the fixing of a date for negotiations with the least possible delay."

* The members were: Sir Archibald Rowlands (Finance Member), Mr. Geoffrey Tyson, Mr. B. K. Madan, Mr. Manu Subedar, Mr. N. V. Gadgil, Mr. Ananthasayanam Ayyangar, Mr. Yusuf Haroon and Sir Ziauddin Ahmed.

† Read Chapter XII.

Fourthly, as part of the action to implement adherence to the International Monetary Fund Agreement, the Report wrote: "We are also informed by the Finance Member that Sections 40 and 41 of the Reserve Bank of India Act 1934, under which the Bank is legally compelled to give Rupees for Sterling and to accumulate Sterling against the issue of Rupees will be amended."

Fifthly, under these circumstances, the Committee recommended to the Assembly that "Government may be authorised to appoint a Governor and an alternate, and Executive Directors and alternates, when this is necessary, but no further financial commitments should be undertaken by Government with regard to the Fund or the Bank before the matter has been further considered by the Committee. The Committee should be summoned to have a report from the Governor on his return from the first meeting of the Boards of Governor of the Fund and the Bank."

On March 1, 1946, the Assembly agreed unanimously to a motion by the Finance Member to accept the Interim Report of the Assembly Committee on the Bretton Woods Conference Agreements. (Read Chapter XII.)

(G) BASIS FOR NEGOTIATIONS:—The contemplated Anglo-Indian bilateral negotiations regarding the method of liquidating India's Sterling Balances will give the foremost place to total Indian needs of capital goods. There can be no doubt, whatsoever, regarding India's capacity to purchase *annually* capital goods worth nothing less than Rs. 300 crores during the next five years, for replacements and for the various plans for industrialization mooted in the country. If Great Britain is unable to supply a large part of the total of capital goods needed by India, then the same must essentially be provided from Dollar sources, so that a proportion of the Sterling Balances must be made immediately convertible into Dollars. Without sufficient Dollar exchange, it would be impossible for India to make the necessary purchases in the United States of capital goods so urgently required by the country. In all fairness to the country, Dollar exchange should be immediately provided in order at least to *replace* plant and machinery which were overworked to death in the process of manufacturing goods essentially needed for the successful prosecution of the war. If India's share in the war effort is to gain recognition from the other Allied Nations, let the country be given at least Dollar exchange to *purchase* capital goods, and not to obtain them as a gift for reconstruction and

rehabilitation of her industries. Further, where British and United States manufacturing resources of capital goods are complementary, decision will have to be taken as regards the proportion which can be best provided under the triangular arrangement. Until England is prepared, that method should be adopted which will release the maximum total of Dollars for Indian use during the next five years.

(H) DR. HUGH DALTON'S ASSURANCE :—The British Chancellor of the Exchequer, Dr. Hugh Dalton, at a press conference on September 29, 1946, promised that all blocked Sterling Balances would be dealt with in accordance with the promises Britain had made in signing the Anglo-American financial agreement. As regards India in particular, he said, "The biggest single holder of these balances is India, though we have not yet tried to discuss the matter with them, because this is a very historic moment in that country's history." He also said, "It seemed to us that it would be right that we should wait for the establishment of a government of Indians by Indians before taking up the subject. So far as the British Government is concerned, the sooner we have such a Government the more we shall be pleased. As soon as this is done—but not until—we shall start on these important negotiations."

CHAPTER XII

Price Movements and Price Control since September 1939

(A) CAUSES OF WAR-TIME INCREASE IN PRICES :—War must be won at all costs and by any means possible or perish. With the outbreak of hostilities all efforts of the Government are concentrated on mobilization of the entire economic resources of the country for the successful prosecution of the war.

1. GOVERNMENT'S PURCHASES AND A "SELLERS' MARKET" :—Economic mobilization in time of war stands on a different basis from that in time of peace in certain respects. Since military organization displaces civilian organization, complete transformation takes place in the form and nature of industrial production. Most of the peace-time production concerns have to be changed over for military uses in the speediest way possible. New plants and factories have also to be set up for the production of materials needed for war. The new military production is on a far greater scale than the peace-time civilian production, and leads to increasing demand for various factors of production. Above all, the *speed* with which military mobilization shall take place, forms the most vital problem for a nation. The more the speed with which tanks, guns, shells, planes, etc., are produced and the more colossal is the scale on which these are produced, the nearer are the chances of victory and of shortening the duration of the war.

All these factors make a Government an *anxious spender*. On the other hand, sellers of materials are well in the know of Government's anxiety to make purchases of vital materials. Consequently, it is a "*sellers' market*". In this factor lies the first germ of rise in prices during war-time.

When war is imminent or has already broken out, shrewd businessmen try to buy up essential commodities in large quantities to stock them and those who already possess them would rather hoard them to sell at far higher prices with the progress of the war. In this struggle is created a "sellers' market". Expectation of shortages of essential commodities must give birth to

feverish speculation and give a constant spur to rise in prices.

2. SWELLING INCOMES AND INCREASE IN PURCHASING POWER :—The expansion in the volume of business consequent on Government's increasing disbursements inevitably increases the volume of incomes in the country. The money incomes of employers, wage-earners, contractors, transporters, merchants, brokers and several other categories of earners, continuously increase as war goes on. The number of wage-earners, in particular, increases several times its pre-war level as a consequence of increase in the number of factories, workshops and other concerns and in the increase in shifts of existing ones. Development of special constructional works, such as building of aerodromes, barracks, bridges, roads, etc., and railways and motor transport absorb several more wage-earners. As a consequence, wages, salaries, profits, dividends all swell, and lead to an expansion of consumers' purchasing power. The increased purchasing power in the hands of consumers increases the demand for consumer goods and thereby creates a " sellers' market ", and as a result a rise in prices. This is what actually happened in India as in other countries.

3. SHORTAGES OF CONSUMER GOODS :—As war production replaces consumer goods the latter contract substantially. Acute shortages in consumer goods also arise as a result of the drastic curtailment of imports due to dangerous seas or scarcity of shipping or scarcity of goods to be had from abroad—a situation which is inevitable in time of war. In order to obtain complete control over various resources needed for war purposes, Governments have had also to curtail civilian consumption as well as investment to meet civil requirements, by directly controlling the demand and supply of such goods. In the case of India, all these factors played a great part in starving the people of most of the consumer goods required.

4. THE DISEQUILIBRIUM LEADS TO INFLATION :—Two phenomena, then, face the country : (i) As just mentioned above, on the one hand, there is continuous expansion of consumers' purchasing power, and (ii) on the other, a continuous curtailment takes place in the supply of consumer goods. The result is a loss of equilibrium between free purchasing power and the opportunities for its use. Spending incomes exceed the

amount of consumer goods on which they could be expanded. If the excess of purchasing power is not mobbed up and diverted to war purposes by methods such as (*a*) Taxation, and (*b*) Borrowing on the part of the Government, it must lead to *inflation*. The disequilibrium in the case of India was very pronounced and led to enormous inflation, as will be explained later.

5. THE CREATION OF NEW MONEY :—These developments involve the methods employed by Governments in financing war-time expenditure. The methods are : (*a*) Taxation, (*b*) Borrowing in the form of loans, Treasury bills, Bonds, etc., and (*c*) Creation of New Money, either by directly printing Notes or by borrowing through the Banking System.

In no country, however, have taxation and borrowing sufficed to solve the problem of financing a war. Governments have been compelled to create new money by printing their own Notes or by borrowing from the Banking System. When this additional money is disbursed by Government, greater purchasing power is poured out. As only a part of the additional incomes created by Governmental expenditure is absorbed by taxation and borrowing, it fails to curtail the demand for consumer goods and develops greater inflationary pressure.

In the case of India, it was the *prodigious issues of Rupee paper money* on the part of the Government against *Sterling Securities* created and invested in British Treasury bills in London, that had an overwhelming influence on inflationary tendencies in the country ; bank credit played an insignificant part in it, as is detailed further in this Chapter.

6. HOARDING AND SPECULATION :—We have referred to the shortages of consumer goods resulting from the concentration of production for purposes of war and from loss of imports. These shortages tend to be aggravated by (i) difficulties of transport and distribution, and much more by (ii) hoarding, and (iii) speculation. It is a common experience that when inflation is in progress, hoarding and speculation always develop, for there are hopes of still greater inflation and the consequent increase in prices. The Compiler of the World Economic Survey of the League of Nations (1941-42, page 122) states : " This is simply the familiar ' flight into commodities ' ; it is a consequence of inflation rather than its cause. But later, it accentuates

inflation." Such factors have played a great part in raising prices, as in India.

7. THE VICIOUS SPIRAL OF INFLATION :—As mobilization for war reaches its peak, all the factors which we have considered above strengthen one another and tend jointly to bring about the *spiral* of : rising prices ⟶ rising costs ⟶ expansion in currency and credit ⟶ rising prices and ⟶ again rising costs ⟶ and so on.

Rising prices tend (i) to raise the cost of living of wage-earners which therefore necessitates increase in wages, and (ii) to raise the prices of raw-materials, stores, etc. So that in course of time, *all costs tend to rise.* To meet these, Government and other employers are forced to borrow more and more from the Banking System leading to continuous expansion of bank credit ; or Government has recourse to further issues of paper money. In either case, inflation is stimulated and prices are pushed up still further. Thus all factors conspire to make inflation cumulative in its effects.

At a later stage of inflation, as when war expenditure is reaching its peak, and expectation of further rise in prices becomes so popular that people are induced to invest their cash balances in purchase of commodities and in shares and stocks, which were already booming on the Stock Exchange. As this tendency develops fast, the price-rise is likely to run ahead of the rate of expansion of money.

In the case of India Government's enormous issues of Rupee-Notes, on the basis of Sterling Securities, far outstripped any attempts at deflation and control of prices, and formed the one outstanding cause leading to the inflationary spiral.

8. PROFITEERING AND BLACKMARKETING :—The mischief caused by the profiteer and the blackmarketeer knows no bounds. They thrive the most during war-time. The shortages of consumer goods and their rising prices during the war, create a vigilant blackmarket. It is the blackmarket that becomes the storehouse for such commodities, and particularly for those most urgently needed by the people. It is the wolf's den where lambs are sacrificed. If the wolf is to be destroyed, death punishment, such as is imposed by the French Republic, is the only measure necessary. The black-

marketeer has done most prosperous business in India, particularly in his trade in certain essential necessaries in the villages inhabited by ignorant masses who easily fell a prey to his wicked cunning. Blackmarket and rising prices acted and reacted on one another.

(B) FAR GREATER INCREASE IN NOTES THAN IN DEMAND DEPOSITS :—In almost every country including India the note circulation increased much more than the volume of deposits during the whole period of the war. This was not only true of those countries where notes have been the chief means of payment, but also in countries like the United States, the United Kingdom and Canada, where deposits constitute a far greater part of the total volume of money than notes. Various factors have contributed towards this shift from deposits to notes. When movement of population takes place as a result of war mobilization notes are more necessary than cheques, with which to make payments. With the establishment and development of war industries and constructional works, there is considerable increase in employment of workers who belong to low-income groups and who require notes for their daily use. Currency hoarding due to panic is another reason which accounts for larger issues of notes. But in the blackmarket cash is very largely demanded because of the necessity to conceal illegal transactions. For this reason, apart from barter, only cash is an acceptable means of settlement on the blackmarket ; and in particular high denomination notes are needed in larger amounts. Further, rationing of foodstuffs and other necessaries have automatically reduced the quantity of such commodities which could be bought at one time. As a consequence, the buying in bulk is replaced by small buyings and at specified periods ; and this has created an increasing demand for notes for meeting purchases of small value ; cheques have little to do with such payments. Whereas the blackmarket generally demands notes of high denomination, rationing requires notes of small denomination.

1. NOTE CIRCULATION THE GREATEST CAUSE OF INFLATION :—Although most of the factors stated above have been responsible for increase in note circulation in India, the most predominant factor as stated previously, was the enormous purchases made in the country of all sorts of materials required for war purposes by the United Kingdom on their own account

and also on behalf of other United Nations. For these purchases, the Government made cash payments through phenomenal expansion of Rupee notes. (Refer to Chapters III and XI.)

Table G below gives the relative increase in Note circulation and Demand Deposits of banks since the beginning of the war.

TABLE G

NOTE CIRCULATION AND DEMAND DEPOSITS OF BANKS

(In crores of Rupees)

Last Friday of	Aug. 1939	Sept. 1940	Sept. 1941	Sept. 1942	Sept. 1943	Sept. 1944	Sept. 1945
1. Note Circulation	169	217	268	493	760	.941	1142
Increase ...		+48	+51	+225	+267	+181	+201
Percentage monthly rate of increase ...		2.2	2.0	7.0	4.5	2 0	2.8
2. Demand Deposits of Banks (Scheduled and non-Scheduled)	141	163	213	324	473	610	672
Increase ...		+22	+50	+111	+149	+137	+ 62
Percentage monthly rate of increase ...		1.2	2.6	4.3	3.8	2.4	1.9

The Table shows that the percentage increase from August 1939 to September 1945 in (1) Notes was nearly 675 and in (2) Demand Deposits was nearly 477. It is also to be noticed that the *percentage* monthly rate of increase of note circulation went up to 7.0 in the twelve months ended September 1941 and declined thereafter to 2.0 during the twelve months ended September 1944 with a slight increase in the next year. Whereas, the percentage monthly rate of increase of demand deposits rose to

4.3 in the twelve months ended September 1942 and declined thereafter to 1.9 in the twelve months ended September 1945.

2. LITTLE INFLATION OF BANK CREDIT :—A noticeable feature of the rise in prices in India is that expansion of bank credit contributed very little towards the inflationary influences.

(i) SUBSTANTIAL FALL IN RATIO OF TOTAL ADVANCES AND BILLS DISCOUNTED TO TOTAL DEPOSITS :—In the first place, there was an almost continuous and substantial ***fall*** in the ***rates*** of total advances and Bills Discounted to Total Demand and Time Deposits. Table G1 given below explains this relationship.

TABLE G 1

Indices (1938-39=100)

AVERAGE OF FRIDAY FIGURES	Total Demand & Time Liabilities (a)	Total Advances & Bills Discounted (b)	% of (b) to (a)
1935-36	92.7	75.6	81.5
1936-37	96.7	82.7	85.5
1937-38	101.7	99.2	97.6
1938-39	***100.0***	***100.0***	***100.0***
1939-40	103.3	108.6	105.2
1940-41	113.0	104.4	92.3
1941-42	134.1	103.7	77.3
1942-43	172.6	81.1	46.9
1943-44	252.0	134.0	53.2
1944-45	327.5	195.0	59.5
1945-46	384.3	195.0	71.2

The Table shows that (i) the Total Advances and Bills Discounted increased from 100 in 1938-39 to 195 in 1945-46, although the

substantial increase began to take place nearing the end of the war.

(ii) The significant fact is that the percentage of Total Advances and Bills Discounted to Total Demand and Time Deposits continuously *fell*, although there was some recovery during 1943-44 and 1944-45. Inspite of the recovery the ratio stood as low as 59.5 as compared with 100 in 1938-39, *i.e.* the Total Advances and Bills Discounted were only 59.5 per cent. of the pre-war total Deposits, in spite of the stimulus to business given by war conditions. This gives support to the fact that the major part of the industrial and business activity was directly financed by the Government, leaving little share to the banks. It was only during the seven months following the closure of the war that the percentage rose to 71.2.

(iii) HEAVY FALL IN VELOCITY OF CIRCULATION OF DEPOSITS :—The velocity of circulation of bank deposits forms an important factor in the inflationary process—the faster it is, the greater is the inflationary effect. The rate at which money is turned over may be roughly obtained by comparing the variations in the volume of deposits with the variations in bank clearings.* When inflation of prices is taking place, the public, if permitted to do so, usually react to the inflationary trend by speeding up the rate at which they spend their money. But it is a remarkable fact that during this war in nearly all countries the turnover of bank deposits substantially *declined* below the pre-war level. This was true even of countries like the United Kingdom, the United States and Canada, where deposit currency forms a far greater part of the total volume of money than notes. In the United Kingdom, in particular, the turnover of demand deposits was on an average nearly 72 per cent. of the basic year 1938.

In the case of India, it is not possible to determine accurately the turnover of deposits since the Clearing House returns of Scheduled Banks contain cheques cleared by non-Scheduled Banks also. Nevertheless, a comparison of the rates of Clearings to Demand Deposits from one period to another will furnish an approximate and general idea of the change in the

* "The indication is of limited value since it takes no account of the note circulation an increasing and in many countries a preponderant part of the total supply of money —Where the turnover-rate of deposits has declined that of notes may well have declined even more as the expansion in notes has been greater than in deposits." *World Economic Survey*, 1941-42, page 181.

velocity of circulation of deposits.

In India the decline in the rate of turnover of demand deposits has been very significant, as is shown in Table G2.

TABLE G2

VELOCITY OF CIRCULATION OF DEPOSIT CURRENCY

YEAR	Average Demand Liabilities of Scheduled Banks (In crores of Rupees) (a)	Indices (b)	Total Clearing House Returns (In crores of Rupees) (c)	Indices (d)	Number of times (c) to (a)
1938-39	123.8	100	1,893	100	15.3
1939-40	132.6	107	2,221	117	16.7
1940-41	155.8	126	2,030	107	13.0
1941-42	200.1	162	2,575	136	12.9
1942-43	306.3	247	2,816	149	9.2
1943-44	456.6	369	4,281	226	9.4
1944-45	584.8	472	5,279	279	9.0
1945-46	654.5	496	6,120	323	9.3

The Table indicates that the main decline in the velocity of circulation of Demand Deposits took place by 1942-43, since when no appreciable further fall has taken place in it. In 1944-45 the index of clearings advanced by 53 points (from 226 to 279) only against an increase of 128.2 points (from 456.6 to 584.6) in the index of Demand Deposits, but the fall in the multiple of Clearings to Demand Deposits reached its *lowest* level to 9.0. A slight recovery, however, took place in 1945-46.

As indicated above, in war, when Government is the biggest single purchaser of commodities as well as biggest single disburser of money, and in both transactions pays mostly in *cash*, the use of cheques becomes severely restricted and accounts for the decline in the velocity of circulation of deposits.

The one intrinsic reason, common to all countries, for the

substantial decline in the velocity of circulation below the pre-war level is lucidly stated by the Compiler of *World Economic Survey* (League of Nations). He states : "Private purchases require both kinds of money. Government purchases require only one ; and as the volume of currency and deposits created by the banking system and spent by the Government increases, while the quantity of goods for private needs is restricted by rationing and allocation, the result tends to be an accumulation of idle funds in the hands of consumers and businessmen, or, in other words, a fall in the 'velocity of circulation'." Indeed, war-time restriction on private spending is one of the factors which contributed to the fall in the velocity of circulation of money ; but it is also due to the desire of the public to leave some of the new money unused.

3. RELATIVE INCREASE IN THE NOTE CIRCULATION IN CERTAIN COUNTRIES :—A glance at the Table G3 given below brings into relief the fact that the largest relative increase in note circulation took place in India, as the indices will show in the last column.

TABLE G 3*

NOTES IN CIRCULATION

(in millions of national currency unit)

Country	1939	End of 1945	Index Number 1939=100
1. Canada ...	233	1,129	484
2. United States of America ...	7,598	28,507	375
3. United Kingdom ...	555	1,380	249
4. Australia ...	57	200	351
5. Switzerland ...	2,050	3,835	187
6. *India* ...	2,245	12,109	539

* Abstracted from League of Nations: *Monthly Bulletin of Statistics*, January 1946.

(C) MOVEMENT OF PRICES AND OF COST OF LIVING : The movement of Prices in India since September 1939 may be divided into distinct periods :—

(A) Upto September 1943 when prices touched the *peak*.

(B) From October 1943 to November 1945 when the gradual decline in prices took place with movements within a comparatively narrow range, owing to the institution of various Price Control measures.

(C) From November 1945 onwards, when prices began to rise owing to rise in food prices.

The important trends of price movements and of the cost of living have been abstracted and shown in Table G4.

TABLE G 4

INDEX NUMBERS OF WHOLESALE PRICES AND COST OF LIVING IN INDIA

(January to June 1939=100)

	WHOLESALE PRICES (Calcutta)	COST OF LIVING INDEX (Bombay Workmen's Index)
1939—September ...	115	102
December ...	139	109
1940—March ...	122	106
September ...	120	108
December ...	121	111
1941—March ...	124	115
September ...	151	124
November ...	159	122
December ...	156	124
1942—March ...	155	132
April ...	159	133
September ...	200	164
December ...	241	181
1943—March ...	275	201
September ...	***353***	236
December ...	305	238
1944—March ...	304	218
August ...	302	***250***
September ...	305	231
December ...	305	228
1945—March ...	310	225
April ...	300	226
September ...	282	240
October ...	283	242
November ...	280	242
December ...	286	242
1946—January ...	287	242
February ...	303	243
March ...	306	247
April ...	308	248
May ...	313	249
June ...	318	***259***

(A) UPTO SEPTEMBER 1943 :—Immediately on the outbreak of the war a steep rise in prices took place up to the end of 1939 which was partly due to high prospects for demand for raw-materials and finished goods for military purposes which led to vigorous hoarding of numberless commodities and partly to the dislocation of import trade. However, there was an unusual and sharp set-back in prices from December 1939 to September 1940, when the all-India Wholesale Price Index fell from 139 to 121. Many factors were responsible for this decline. Thus, restrictions were placed on exports and the imposition of the Excess Profits Tax created nervousness among producers, at the same time some Price Control measures, however inadequate, were introduced. But the most important factor was the failure of war demand to materialize, which actually led to dishoarding of commodities.

But as the year 1940 closed, prices began to recover and there was a steady rise right upto November 1941 when the Price Index had reached 159. Although India had by this time lost many important markets, the effects of the various factors, enumerated in Section (A) above, began to manifest themselves. But the steep ascent in prices started from April 1942 which galloped on to September 1943, when the Price Index reached the peak of 353.*

The principal cause was the enormous issue of notes which were entering circulation, coupled with the fact that Price Control machinery was just being inaugurated.

(B) FROM OCTOBER 1943 TO NOVEMBER 1945 :—Vigorous measures were adopted to check the upward spiral of prices during the last quarter of 1943 and were continuously extended during 1944 and 1945, and by March 1945 the Price Index had reached 310. It will be seen from Table G4 that the Price Index was brought down within three months from the peak of 353 in September 1943 to 305 in December 1943, that is, by 48 points. Thereafter, the range of variation was between 305 and 310. The rise in prices was not only halted but was brought down owing to rigid measures of Price Control, inspite of continuous increase in note circulation. The decline in prices continued up to November 1945.

* However, the Index Number of Wholesale Prices formed by the Office of the Economic Adviser to the Government of India showed 236.3 as the figure for September 1943. This Office's peak figure was 250 in January 1945.

(C) FROM NOVEMBER 1945 ONWARDS :—However, the food situation in India greatly deteriorated due to (i) the slackness in the enforcement of monopoly procurement in surplus Provinces like the Punjab, Sind and Bihar, (ii) the inadequacy of imports, and (iii) climatic reasons like cyclones, floods and droughts in several parts of the country, particularly in deficit areas like Bombay, Madras and the Mysore State. The over-all shortage of food grains for the year 1946 was estimated at between four and six million tons. As a result prices have gone up steadily to 318 in June 1946.

Table G5 gives a comparison of the *average* Index Numbers of Wholesale Prices compiled by Calcutta and by the Office of the Economic Adviser to the Government of India.

TABLE G 5

AVERAGE INDEX NUMBER OF WHOLESALE PRICES

	Calcutta	Office of the Economic Adviser
1939-40	109	125.6
1940-41	121	114.8
1941-42	141	137.0
1942-43	187	171.0
1943-44	311	236.5
1944-45	302	244.2
1945-46	292	245.0

As the above Table shows, there was great discrepancy between the two Indices, particularly for the years 1943-44, and 1944-45 and 1945-46.

Table G6 gives an abstracted list of Index Numbers of Wholesale Prices in India by Groups of Articles, since 1942-43, prepared by the Office of the Economic Adviser to the Government of India.

TABLE G6

WHOLESALE PRICES IN INDIA BY GROUPS OF COMMODITIES (ABSTRACTED)

(Week ending 19th August 1939=100 ; Source : Economic Adviser to the Government of India)

	AGRICULTURAL COMMODITIES	RAW MATERIALS	PRIMARY COMMODITIES	MANU-FACTURED COMMODITIES	CHIEF ARTICLES OF EXPORTS	GENERAL INDEX
1942—April ...	129.9	162.3	141.7	162.5	139.5	146.0
Septembter ...	156.3	163.1	159.0	179.2	152.6	163.1
1943—March ...	238.4	172.0	210.0	227.0	210.4	213.5
June ...	**284.1**	178.4	237.1	257.5	143.2	241.4
September ...	272.0	181.4	232.4	251.3	238.2	236.3
1944—March ...	248.4	196.7	226.9	252.3	226.7	232.1
September ...	265.3	203.2	239.2	**259.0**	244.5	243.3
1945—January ...	275.3	**211.6**	**248.5**	257.1	**249.7**	**250.3**
March ...	273.6	208.7	246.2	253.7	249.8	247.8
September ...	264.2	210.8	241.9	242.9	246.2	242.2
October ...	268.7	210.8	244.5	242.9	248.4	244.1
November ...	271.1	210.8	245.9	236.0	246.4	243.6
December ...	278.5	211.7	250.3	235.8	249.1	247.1
1946—January ...	285.4	211.2	253.9	237.3	253.5	250.2
February ...	291.5	210.3	256.7	239.2	257.4	252.8
March ...	295.7	206.3	257.1	240.2	261.0	253.3
April ...	294.3	206.1	256.3	240.6	262.8	252.7
May ...	299.3	207.4	259.6	239.2	266.7	255.0
June ...	**318**					

The above Table shows that during the *war period* (i) the Index Number of Agricultural Commodities reached the *peak* of 284.1 in June 1943 and thereafter varied within a range of 11 points up to March 1945. (ii) Whereas, the Index numbers of Raw-Materials, Primary Commodities, and Chief Articles of Export reached their respective *peaks* of 211.6, 248.5 and 249.7 in January 1945, bringing the General Index to the peak of 250.3. (iii) The Index Number of Manufactured Articles reached the *peak* of 259 in September 1944. (iv) The highest relative increase in Index Number was of Agricultural Commodities.

But since September 1945 the Index Number of Agricultural Commodities rose steadily until it reached 299 in May 1946 and the general index reached 255 at this time. In June 1946 a disquieting rise in agricultural prices took place to 318.

It would be of interest to compare the highest levels to which Wholesale Price Indices reached in India and in important foreign countries for which data are available. Table G7 shows at a glance how predominant is India's peak Index Number as compared with the rest.

TABLE G 7

***PEAK* INDEX NUMBERS OF WHOLESALE PRICES**

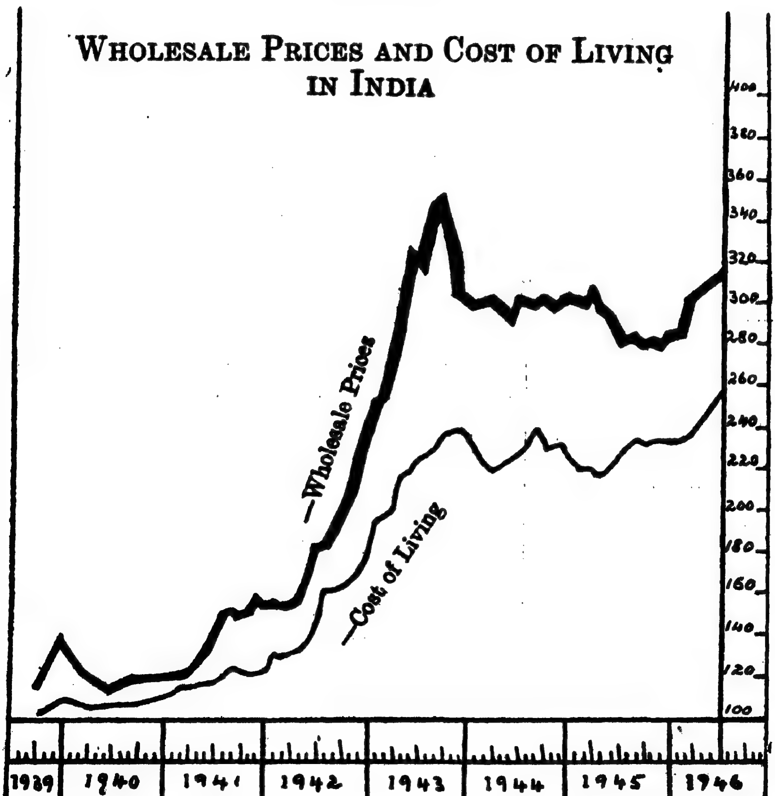
COUNTRY	PEAK INDEX NUMBER	DATE OF REACHING THE PEAK
India	353	September 1943
United Kingdom ...	172	July 1944
United States of America	138	February 1945
Canada	141	March 1944

Indeed, the circumstances under which the Price Indices are constructed in various countries vary considerably, and it is not correct to have any satisfactory comparisons of their relative figures. Still they help to give us a rough notion of their relative values.

RISE IN COST OF LIVING :—Concomitant with the rise in wholesale prices the cost of living also rose. The only comparatively reliable statistics of cost of living are those prepared

for the working class by the Bombay Labour Office. Reference to Table G4 will show that the Bombay Cost of Living Index rose steadily until it reached the war-time peak of 250 in August 1944. But thereafter, it tended downwards and stood at 217 in March 1945. From this low level it resumed the upward trend and reached 242 in October. At this level it remained more or less steady till January 1946, and since then it has crept up steadily owing to the continued rise in food prices, until the *all-time peak level* was reached at 259 in June 1946. The following Diagram 1 depicts the relation between Wholesale Prices (Calcutta) and Cost of Living (Bombay) :—

DIAGRAM 1.



The Indices of Cost of Living, however, do not present a correct picture of the miseries imposed on the large majority of people.

Price Indices and Indices of Cost of Living are the products of official price quotations based on traditional red-tape methods and both these are wanting in accuracy. Weights of certain commodities which are the vital components of the Index seem to have been changed only on anticipations rather than on actual facts collected. Rationing of certain cereals, like rice and wheat, was introduced comparatively very late during the period. But the General Index of cloth reached the peak of 513 in June 1943 and took one year to reach 300. Apart from this, units of cloth such as the Dhotee, fundamentally necessary for the whole Hindu race comprising nearly 300 millions, and the Saree necessary for the whole Indian womanhood, were beyond the reach of a normal person to obtain for a considerable part of the period under review, except at prices more than five times the pre-war prices. Besides, fire-wood reached the record level 340 by the middle of 1944 and remained at nearly 300 up to December 1945. Cooking-oils (Til, Groundnut and Linseed) reached the peak of 320 as late as January 1946. The lowest quality of champals (footwear) were being sold at an average of 310 and umbrellas at as high a figure as 450 by end of 1944.

But leaving aside the factor of the extraordinary rise in the Cost of Living Index, large parts of the population, the farmer class, living at or near the subsistence level, were *starved* of cloth, kerosene oil and most of the other essential usable commodities, and as a consequence, their incentive to sell their food produce was reduced ; and they retained more of it for hoarding. If they were compelled to purchase these commodities, they had to be tools of the black-market. The middle class too were large sufferers. During the six years of the war they too were *starved* of many essentials and most of the conventional necessaries of daily use. This starvation is carried well nigh into 1946 with slight improvement in the situation. We are being made to live in a period of " patched " commodities, but even the last possible patches have been exhausted. Finally, the heavy deterioration in quality of commodities supplied to the people in the country has to be reckoned with—a factor which is never reflected in the Indices charted out by official procedures.

As in the case of Wholesale Price Indices, a comparison of the *peaks* of Cost of Living Indices in certain countries in war-time is given in Table G8.

TABLE G 8

WAR-TIME PEAK INDEX NUMBERS OF COST OF LIVING

COUNTRY	PEAK OF COST OF LIVING.	DATE OF REACHING THE PEAK
India*	250	August 1944
United Kingdom ...	131	November 1941
United States of America	128	August 1944
Canada	119	August 1943

(D) MEASURES OF PRICE CONTROL :—The Government of India had utilized four principal methods of financing war-time expenditure on behalf of the British Government and of themselves, namely : (i) taxation, (ii) borrowing, (iii) promotion of savings, and (iv) the creation and spending of new money.

While taxation, borrowing and savings were methods deflationary in their effects, the creation and expenditure of new money in India was highly inflationary and far *outclassed* all attempts at successful anti-inflationary measures and therefore at control of prices. As mentioned previously, prodigious issues of Rupee-notes in India were undertaken to finance the British Government's expenditure on purchases meant for themselves and for other Allied countries. These Rupee-notes were issued on the backing of Sterling Securities created in favour of India in *London* in the form of British Treasury bills.

Inflationary forces can be counteracted (A) by substantially reducing the volume of money in circulation, so that the *excess* purchasing power could be *mopped up*, and (B), if continuous expansion of money is unavoidable, then in order to minimize its effects, vigorous measures should be utilized for placing *effective control on prices* of commodities and services and *on the cost of living.*

(A) MOPPING UP EXCESS PURCHASING POWER :— It is of great economic value to learn that in World War II taxation and other current revenue covered a very large propor-

*** It has been stated that the *all-time* peak level 259 was reached in June 1946. The above Table shows the war-time peak figure.**

tion of total expenditure and was employed much more efficiently for curtailing excess purchasing power and controlling inflation than it was during World War I. Table H gives the proportion of Government Expenditure covered by Revenue in 5 years (1939-1944) by certain countries. It shows that in India the proportion was the highest and bears testimony to the heavy sacrifices which the people of the country were called upon to bear.

TABLE H

PROPORTION OF GOVERNMENT EXPENDITURE COVERED BY REVENUE IN 5 YEARS (1939-40—1943-44)*

COUNTRY	PERCENTAGE OF REVENUE TO GOVERNMENT EXPENDITURE
India	72
New Zealand	71
Canada	60
Australia	49
Switzerland	49
United Kingdom	48
United States of America ..	41

(*a*) BY DIRECT TAXATION :—However, *direct* taxation is a most useful instrument to offset excess purchasing power. It is, therefore, important to measure the effects of the imposition of taxes on Income in India as a part of the Total Tax Revenue. This is done in Table H1 below :

* League of Nations: *World Economic Survey*, 1942-44, page 165.

TABLE H 1

PROPORTION OF INCOME TAXES TO TOTAL TAX REVENUE IN INDIA

(In crores of Rupees)

	Total Tax Revenue (including Provinces' share) (a)	Taxes on Income (including Excess Profits Tax) (b)	Percentage of (b) to (a)
1938-39	76.35	17.28	22.6
1939-40	81.85	19.37	24.0
1940-41	79.66	25.93	33.0
1941-42	103.26	44.06	43.0
1942-43	132.04	78.00	59.0
1943-44	193.22	129.14	66.8
1944-45	300.58	210.00	69.9
1945-46	313.02	179.00	60.4
1946-47 (Budget)	272.97	149.35	50.7

The above Table H1 brings out the remarkable increase in Taxes on income from Rs. 17.28 crores in 1938-39 to the peak of Rs. 210 crores in 1944-45.* But more striking is the *percentage* of Income Taxes to Total Tax Revenue, which rose from 22.6 in 1938-39 to 69.9 in 1944-45.†

The total amount mopped up by Income Taxes since 1940-41 was Rs. 868.13 crores in *six* years.

(1) IMMOBILIZATION OF EXCESS PROFITS :—In order to assess the anti-inflationary effect of the war-time increases in income taxation we would have to include the various compulsory deposits under the Excess Profits Tax and Income Tax.

* In the Report on Currency and Finance, 1948, it is stated that the limits of possible increase in direct taxes were approached in that year.

† As a matter of comparison it may be stated that in the Budgetary Estimates for 1944-45 the proportion of Taxes on Income (including Excess Profits Tax) to total Tax Revenue was 59.8% in United Kingdom, 80% in the United States of America and 62% in Canada.

By an Ordinance on 17th May 1943, a system of *summary assessment* of Excess Profits Tax was introduced by which the tax would be collected at once, being assessed on a commonsense basis and the differences only in the amount actual and collected would be settled at the end of the year. This led to very large sums being immediately withdrawn from circulation instead of being left over for a whole year for speculative purposes in the market. Similarly the share of the Excess Profits remaining with an assessee after the share of the Government was paid in the form of the Excess Profits Tax, was *compulsorily to be deposited* with the Government. The result was that Excess Profits were immobilized to the extent of 100 per cent. Besides, by the " Pay-as-you-earn " scheme, assessees were induced to pay taxes on income as quickly as possible and the scheme thereby formed an anti-inflationary measure.*

(2) CONTROL OF BONUSES AND STOCKS :—On the same date a new measure was also introduced which empowered the Government to restrict the amount of bonuses and commissions which shall be admissible for income-tax purposes and the amount of stocks which shall be considered reasonable in the same connection. If large bonuses are paid by companies to shareholders, it would deprive the Government of large amounts ; and at the same time, the investment of bonuses in the purchase of commodities or on the stock exchange would encourage speculation and help towards further inflation and rise of prices. The measure was therefore preventive in its purpose.

There was also the danger that large manufacturing concerns might hold very large stocks of raw-materials or stores by increasing the amount of capital so invested, and in so doing derive some advantage in respect of income-tax payment. Large stocks of raw-materials and stores would on the one hand partake of the nature of hoarding, and on the other create heavy shortages and force up their prices. By this new measure the freedom which the existing income-tax rules gave to such a process was withdrawn.

(*b*) BY BORROWING AND PROMOTION OF SAVINGS :—In order to absorb excess purchasing power the other weapons used were (*a*) borrowing, and (*b*) promotion of savings. The

* No official data are available concerning the Compulsory deposits under the E. P. Tax System and the " Pay-as-you-earn " Scheme.

extent to which these methods were effectively utilized is shown in the figures of Public Debt of India in Table H2 given below :

TABLE H 2

PUBLIC DEBT OF INDIA

(In crores of Rupees)

END OF MARCH	LOANS I	TREASURY BILLS II	Post Office Savings Bank Deposits & Cash Certificates III	Other Obligations IV*	TOTAL
1939	537.86	46.30	141.46	84.34	709.96
1945 (Preliminary)	1,216.87	86.71	157.52	115.71	1,571.85
1946 (Preliminary)	1,492.18	83.33	220.28	131.76	1,927.55

The above Table H2 shows :—

(1) that the total Public Debt outstanding by end of March 1946 increased by 271 per cent. over 31st March 1939 ;

(2) that the total deflation that took place was to the net extent of Rs. 1,217.59 crores during these years. Of this total deflation, the largest share was by the issue of Loans, which totalled the net amount of Rs. 954.32 crores. A great variety of Securities was offered to investors, including loans with lottery features, in order to attract funds from various types of investors ;

(3) that the Treasury bills outstanding on 31st March 1945 were nearly twice the amount outstanding on 31st March 1939, being very popular with the banks for investments ;

(4) that the net increase in savings (Item III) was of only Rs. 16.06 crores during the period 1939-45. In fact, the Savings Schemes had a poor response from the public. It was only after April 1945 that the increase in savings was substantial. These small Savings Schemes were particularly introduced to induce savings of lower middle class people. But high prices pressed heavily on their

* Includes items such as unclaimed balances of Old Loans; Balances of special loans relating to endowments; State Provident Funds, Pension Funds, etc.

cost of living and left little savings for investments. At the same time strong complaints were heard from several parts of India that savings were being pooled under pressure from administrative officers.

(*c*) SALES OF GOLD :—Sales of gold are a very powerful deflationary weapon, because they bring notes into the vaults of the Reserve Bank, which can be *cancelled*. Such sales were undertaken in a few months during all the war years by the Reserve Bank of India to the extent of nearly Rs. 50 crores on behalf of the Treasuries of the United Kingdom and the United States of America.

(B) DIRECT AND INDIRECT CONTROL OVER PRICES: Until the end of 1942 nothing substantial was done to prevent prices from soaring up, except fixing *maximum* prices of certain commodities. In India price ' ceiling ' became the starting point for economic controls. Unfortunately, as Government lacked the machinery to impose an effective price control system, the result of fixing ceiling prices was to drive stocks of supplies underground and give rise to black markets. For example, this happened regarding wheat, even in the markets of producing areas as the Punjab and the United Provinces. The scarcity thus created fear in the minds of the people who, wanting to be assured of the supplies of commodities they required, hoarded enormous stocks of them. This accentuated the scarcity still further and inflicted great hardship on the majority of the population, who could not afford to stock the commodities and who were therefore driven to the black markets for necessary purchases. Rising prices created black markets and black markets led to still higher prices. When purchasers of uncontrolled manufactured articles sold them in black markets to make huge profits, manufacturers themselves sold their articles at inflated prices. Besides, when some commodities only were officially controlled, holders of other uncontrolled commodities began to hoard them, fearing that they too would sooner or later be brought under control. This pushed up prices of uncontrolled commodities. Speculators in commodities had a very merry time during these three years and they played the greatest part in raising prices. In fact, at the beginning of the fourth year of the war the price control policy was " confused and amateurish. It betrayed conflict and competition of Central and Provincial

objectives. That it had not been inspired as yet by economic foresight is clear from the fact that the price control policy is still being tackled in vacuo."*

The policy of having different controls in different Provinces, which in some ways worked as rivals, particularly with regard to distribution of food-grains, brought about a totally unco-ordinated and confused position.

(1) CONTROL OF FOOD PRICES :—The stabilization of food prices is a powerful anti-inflationary measure because rising food prices are closely related to the rise of other prices. It is an effective anti-inflationary weapon in India because nearly 80 per cent. of the cost of living of nearly 80 per cent. of the whole population is made up of food-cost. For the success of this policy certain fundamental conditions should be fulfilled :

(i) there should be a *unified* national food policy, (ii) there should be *centralized* control over the entire supply and distribution of food-grains, and (iii) there should be centralized Statutory Control over all food-grain prices.

The first noteworthy step taken in early 1942 was the *Food-grains Control Order* which insisted on *licences for traders to* trade in food-grains above 20 maunds. It did not apply to producers or their tenants. An Order was issued on the 12th August 1942 prohibiting advances against food-grains unless they were held by a licensed dealer or producer. On the 6th October 1942, an order was passed freezing stocks of wheat hypothecated to banks in the Punjab and Punjab States as security for loans, with a view to subsequent acquisition by the Government.

It was, however, as late as December 1942 that the *Food Department* was set up for the purpose of integrating all the activities in regard to the purchase, movement and distribution of food-grains on an *all-India* basis. The main problem facing this Department on its creation was the existence of black markets on a very large scale and drying up of supplies from markets in most of the producing centres. The Department, therefore, decided to abandon the control over the price of wheat from 25th January 1943. This decontrol immediately led to a rise in the price of wheat from the control price of Rs. 5 to

* *The Economist*, 26th December 1948 — A correspondent.

Rs. 12 per maund, but at the same time the supplies of wheat were attracted to the market which enabled Government to purchase large quantities.

A Plan of the Food Department, called the ***Basic Plan***, came into operation from 1st April 1943. Under the plan over a period of the next 12 months it was expected to procure about 4,000,000 tons of food-grains from the *surplus* areas on behalf of the Central Government and *distribute* this quantity among the *deficit* areas. But the Basic Plan operated for a period of $3\frac{1}{2}$ months. While it worked with tolerable success in regard to certain areas, it completely failed to ensure a planned supply of food-grains to the areas in great distress, *viz.* Bengal in the North-Eastern Region. The supplying areas, *viz.* U.P., Bihar, Orissa and Assam, found it impossible to fulfil even a fraction of their obligation " for fear of aggravating their own difficulties," and Calcutta was reported to be in a desperate position of having only a few days' stock on hand. The Basic Plan was therefore abandoned and a free trade zone was declared.

But the abandonment of control brought profiteers and hoarders into the markets who held them or sold them in the black market. Consequently, Bengal could only purchase the supplies at sky-rocket prices and the supplying areas themselves also found prices soaring high. In utter dismay, the Government of India therefore decided to abrogate the free trade experiment. Such was the confusion in which the Government was rushing from one step to another.

EVOLUTION OF AN ALL-INDIA FOOD PRICE POLICY : The Government of India appointed the *Food-grains Policy Committee*, presided over by Sir Theodore Gregory, Economic Adviser to the Government of India. This Committee laid the foundation of the *entire long-term food-grains policy* for the country. Central Control and Co-ordination of food-grains seem to have now begun, although after incalculable hardships inflicted on the people of India during the first four years of the war. The average price of rice in Calcutta had risen from Rs. 4-8-0 per maund in 1939 to nearly Rs. 34 per maund in August 1943. The price of wheat rose from Rs. 3 per maund in 1939 to Rs. 11 per maund in August 1943 at Lyallpur.

The principal recommendations of the Food-grains Policy Committee related to the following : (*a*) The Imports and Exports of

food-grains, (*b*) the Basic Plan, (*c*) Procurement, (*d*) Statutory Price Control, and (*e*) Rationing.

We shall deal with each of these :—

(*a*) *As regards Imports and Exports of food-grains* :—The Committee recommended that India must cease, for the duration of the war, to be a net exporter of food : no exports should be permitted unless such exports are fully compensated by imports, in addition to those mentioned below. No export of rice should be permitted at all. As regards imports, the Government of India should press for imports to create a Central Food-grains' Reserve which should not be less than **500,000** tons. Such a quantity was found absolutely necessary to prevent a breakdown of the other measures proposed ; also to request the United Nations to arrange for imports of food-grains for current consumption, which should be at least one million tons. This request was strongly urged on the main ground that owing to the low *per capita* standards of consumption generally prevailing in India as a whole, the degree to which subsistent levels could be cut was considerably less than in more fortunately situated countries.

(*b*) *As regards the " Basic Plan "* :—The Committee emphasized the importance of determining as accurately as possible the surpluses and deficits of food-grains in India, in order to be sure of the assistance which surplus areas can give to deficit areas. They recommended a uniform procedure for the Provinces and proposed a standard formula to be adopted : Normal consumption requirements should be taken as the average of the estimated harvests of all the food-grains over a period of 5 years ending 31st March 1942 plus/minus the average imports/exports of the same period. Surpluses and deficits should be calculated on the basis of normal consumption thus determined, compared with the estimates of the forthcoming year's/half-year's production of all food-grains. The figures of the Basic Plan should be kept continuously under review and readjustment if necessary.

(*c*) *As regards Procurement* :—The Procurement problem, they stated, was not primarily an issue of moving supplies from surplus Provinces to deficit Provinces, but of acquiring from the cultivator the ***maximum*** amount to be obtained from every part of India. From the standpoint of principle the only satisfactory solution would be a Central Government Food-grains Monopoly. But the problems of organization and administration were so great that the necessary time was lacking. In the meantime, the Centre should entrust its physical procurement operations to the agencies set up by the Provinces and States but subject to

the right of the Centre, if the procuring agency proves unsatisfactory, to insist upon remedial measures being introduced and a Central Enforcement Branch should be established for this purpose. The objective of all procurement machinery should be to eliminate competitive buying to the greatest possible extent.

(*d*) *As regards Statutory Price Control* :—Regarding the control of food-grain prices the important recommendations made by the Committee were :

(i) That *statutory price control* should be instituted for all major food-grains in *all Provinces* and also similar control of an increasing number of non-agricultural commodities, particularly those necessary to the cultivator, should be undertaken.

(ii) That the minimum conditions precedent to the establishment of statutory price control are (*a*) adequate procurement machinery, (*b*) rigorous and drastic enforcement of the Food-grains Control Order and of Anti-hoarding measures, and (*c*) effective control over transport. To attain the maximum chance of success, statutory Price Control requires the existence of a Central and also of Provincial and State reserves.

(iii) That Statutory prices should not be fixed without the consent of the Central Government. The Centre should have the right to suggest changes of prices both upwards and downwards.

(iv) That a small Standing Prices Committee representative of the Centre, the Provinces and States, producers and the trade, should be set up at the Centre.

(v) That in considering the level of prices of food-grains appropriate to a particular area regard should be had to (*a*) the cost of articles entering into the cultivator's cost of production, (*b*) cost of articles entering into his standard of life, and (*c*) cost of cultivation of marginal lands.

(vi) That pending the enforcement of Statutory Price Control *throughout India*, such Provinces as desire to enforce Statutory Price Control or Ceiling Prices should be permitted to do so subject to the approval of the Statutory or Ceiling Price by the Central Government.

(*e*) *As regards Rationing* :—The Committee stated that the general case for urban rationing was overwhelming and that rationing should be introduced forthwith in the larger cities all over India, in the first instance in those with populations of

one lakh and over and should be progressively extended. They also suggested that the *standard ration of cereals per adult per day should not be allowed to fall below* 1 *lb.*

VIGOROUS ENFORCEMENT OF A DEFINITE FOOD PRICE POLICY :—These recommendations of the Food-grains Policy Committee were implemented during 1944 and more fully and with greater speed and vigour during 1945. It was during these years that large imports of food-grains took place, rationing was very widely extended, statutory price control was undertaken and the "Grow More Food" campaign was launched which brought with it extra production of food-grains.

But the introduction of the system of *Government monopoly of compulsory procurement* of food-grains from the producers was an important development during these years. If the maximum of food-grains could be pooled and purchased by the Government at the very *source of production* and Government themselves sold the produce, Government would have the sole control over both the buying price and the selling price of food-grains. In this process lay the real secret of the success of Statutory Price Control. But an adequate return should be ensured to the producer, if he was to be induced to sell the maximum amount of what he had produced, after keeping the quantity required by him for his own family's consumption and for seeds during the season. The Central Government, therefore, issued instructions to Provincial Governments that, while the Food Policy of the Government was to ensure adequate production at fair prices to the consumer, they should not allow prices to decline to such levels that an adequate return was not ensured to the producers of food-grains. Instructions were issued to support the market, as in the case of wheat and jowar, wherever prices showed a tendency to decline unduly. However in a country of enormous distances and with most inadequate transport, leakages in monopolistic purchases of food-grains are always possible. To prevent this, the only recourse was to enforce vigorously the Food-grains Control Order (1942).

Further, in the emergent conditions that prevailed in India then, it was impossible to introduce all at once *All-India* Statutory prices for all food-grains. This position had to be reached by stages and the policy was explained by Mr. R. H. Hutchings, Secretary to the Government of India, at the Fourth Food Con-

ference, on the 16th October 1943. He stated : "We consider that it will become possible to introduce such (all-India) price control by building up control first of all on a provincial basis, then on a regional basis : and then, as the emergent situation disappears and as efficient procurement and distribution arrangements, supported we hope by substantial imports from abroad, enable Government to regain control of stocks, it will become possible to contemplate all-India price control."* Such was the Price Policy followed during the succeeding years. The essence of success of the policy, however, depended on the Government's ability to acquire from the producer of food-grains the *maximum* he could sell, without coercion on the part of administrative officers or inflicting on him any other hardship. Once the maximum quantity of food-grains was secured, the rest was a comparatively easy matter. Transport of food-grains could be arranged by the Government in pursuance of the Basic Plan, from the surplus to the deficit areas, more efficiently than private individuals, for the railways are a State monopoly. But during the period of the war and the few months following its closure, railway wagons were pooled by the War Transport Department for military purposes, leaving a heavy shortage for civilian purposes. It was only when more and more wagons were released by the War Transport Department that the distribution of food-grains became more even and effective and tended to reduce wide variations in prices between different areas of the country. According to a new Food Index issued by the office of the Economic Adviser since February 1944, (base : week ended the 26th August 1939 = 100), the wholesale price of food comprising 11 important articles, showed a decline from 243.4 in February 1944 to 234.2 in June 1945, and the range of variations was of 9 points. But thereafter, owing to failure of rains in several parts of India, the Food Index again rose until it reached 244.8 in March 1946.

INFLUENCE OF RATIONING ON CONTROL OF FOOD PRICES :—That rationing had a share in holding down prices could not be denied. A successful Procurement Policy prepares the ground for a comprehensive Rationing Scheme. Food Rationing guarantees to every individual the *minimum* quantity of food articles necessary for him. It *distributes short supplies*

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* Government of India: *Food Situation in India*, 1944, page 20. "But our ultimate conception of a statutory price control is a price fixed for a crop which will remain fixed throughout the crop season." (Mr. R. H. Hutchings.)

in an equitable manner: At the same time, it reduces unnecessary consumption, prevents a run on a commodity in short supply and prevents hoarding and profiteering. When supplies are short, rationing is absolutely necessary to ensure fair distribution to all.

Food Rationing must go hand in hand with Price Control : each helps the other. Mr. W. H. Kirby, Rationing Adviser to the Government of India, during the course of the Food Debate in the Central Legislative Assembly, explained the relation between Rationing and Price Control very lucidly. He said : " No price control can withstand unaided, the pressure of increasing demand on dwindling supplies, and it must be accompanied by quantitative controls over demand and supply. Equally, rationing requires price control. Since no matter how widespread rationing is, it will not ensure equitable distribution among all income groups unless prices are low enough to enable everyone to buy his ration."

The progress of rationing in India is almost a world record. By the end of March 1943 only 19 lakhs of people were rationed, but by the end of June 1946, 1,300 lakhs of people were rationed for cereals and sugar. To have rationed within three years nearly one-third of the huge population of India is an achievement as wonderful as it was helpful in bringing about relative stability of food prices in the country. All honour to Bombay which initiated the Rationing Scheme and made it an enviable model of organization and efficiency not merely for the rest of India but also for most other countries of the world. Credit, indeed, goes to the team of Bombay Organizers headed by the great Crusader of Rationing, Sir Henry Knight, the Adviser to the Bombay Government, and his able lieutenant, Mr. A. D. Gorwala, I.C.S., Secretary to the Government of Bombay, Food Department.

(2) CONTROL OF CLOTH PRICES :—A new Department of Industries and Civil Supplies was constituted in April 1943 which immediately considered the cloth situation and in June of this year, with the co-operation of the Mill industry, set up a *Textile Control Board* which was to look after the stimulation of cloth production and its distribution and to advise Government in the control of prices of cotton yarn and cloth. A Textile Commissioner was also appointed. Steps were taken

to increase production of cloth through rationalization of production, adoption of multiple shifts and other methods. The "standard cloth" was evolved and orders were placed, in the first instance, for the delivery of 1,000 million yards of such cloth intended for the poorer classes of the people by the end of 1943. Earlier in May 1943 in order to stabilize the prices of raw cotton, hedge contracts in respect of both the new and current crops were banned. Further, dealings in forward contracts in cotton cloth and yarn were prohibited since 24th June 1943.

Under the *Cloth Control Scheme*, which was promulgated in June 1943, provision was made to ensure proper movement of stocks from the mills to the consuming centres. The object was to prevent the hoarding of stocks of cloth by producers, dealers and consumers and bring every yard of cloth produced for consumption. But a remarkable step taken was the policy of *forcing supplies of cloth on to the market*. After the fixing of maximum prices in June 1943, all supplies in the hands of merchants had to be stamped with the fixed price and the date of manufacture. All unstamped cloth had to be sold off before 1st January 1944, under penalty of confiscation or heavy fines. By this method, Government succeeded in forcing on the market a huge quantity of cotton cloth which had previously been hoarded by the merchants. These disgorged stocks together with the new stocks were instrumental in bringing down the prices of cloth in both wholesale and retail markets. "In some of the retail markets," observed His Excellency the Viceroy, in his speech before the Central Legislative Assembly on 2nd August 1943, "the prices have fallen by more than 40 per cent. Ceiling ex-mill and retail prices have been fixed for most of the standard varieties of cloth. A fair margin has been allotted to wholesale and retail dealers for the cost of transport and other incidental charges and for profits. The ultimate price to the consumer cannot be more than 20 per cent. above the ex-mill prices, which is the permitted margin."

The wholesale index number of Cotton Manufactures declined from 513 (peak) in June 1943 to 274 in March 1945. Between October 1944 and March 1945 the variations in the indices of cloth were confined to 11 points (from 285 to 274 respectively).

(3) CONTROL OF CAPITAL ISSUES :—In May 1943 a new Rule was issued prohibiting, *inter alia*, without the prior

consent of the Central Government, the issue of capital in British India, any public offer of securities for sale in British India, and the renewal or postponement of repayment of any security maturing for payment in British India. This new Rule had the effect of (*a*) preventing the growth of mushroom companies which stood little chance of survival in the post-war period and of (*b*) being anti-inflationary.

As there was a serious shortage of many of the most essential goods and services required for manufacturing concerns, by having a strict control over the issue of new capital, it was possible to prevent a scramble for the available supplies, which could only result in raising prices still further. It was therefore an indirect anti-inflationary measure. At the same time new enterprises could be canalized into producing only those goods which were absolutely necessary for civilian and war purposes. There was also the danger lurking in uncontrolled issue of capital that some or most part of it may be diverted to speculative uses, such as the financing or hoarding of scarce commodities and loans to the Stock Exchange.

(4) PREVENTION OF HOARDING AND PROFITEERING :—The Hoarding and Profiteering Prevention Ordinance passed in October 1943 sought to keep within reasonable limits the stocks of consumer goods held by dealers and bring down the retail prices to a reasonable level. In this connection holders were compelled to declare their stocks of certain commodities. Besides, this Ordinance provided for a general control over all unexempted articles and *nothing could be sold at a price exceeding 20 per cent. of its landed cost or cost of production.* Thus, placing a legal limit of 20 per cent. on profits was a very effective measure of price control.

Several articles were brought within the scope of this Ordinance in course of succeeding years and with a view to strengthening the Price Control measures adopted under this Ordinance and to preventing available supplies from going underground, a new Order was issued in July 1944, called the Consumer Goods (Control of Distribution) Order. This had the effect of regulating supplies, distribution and prices of consumer goods including imported commodities and helped towards effective control of prices.

(5) ANTI-SPECULATIVE MEASURES :—The method of fixing 'ceiling' prices, although useful in many cases, cannot

prove effective in preventing speculation. Direct steps should be taken to weed out the speculator. Thus, series of measures were adopted regarding food-grains. The Food-grains Control Order (mentioned previously), if vigorously enforced, was a very effective weapon in segregating the speculator from the bona fide trader. Another measure to eliminate the speculator from the grain trade was Rule 44-B which prohibited the making of money advances against grains, unless the person held a licence to trade in grains or possessed food-grains produced by him or his tenant. Further, the Food-grains (Futures and Options Prohibition) Order, 1942, had for its object the control of speculative transactions and forward purchases likely to affect price tendencies and conserving of food-grains on large-scale.

We have also mentioned the Cotton Forward Contracts and Options Prohibition Order which was promulgated on 1st May 1943, which prohibited all persons from entering into (*a*) any forward contract for the sale or purchase of cotton in respect of new crops, and (*b*) any option in cotton. Similar Orders were issued to fight the speculative activities in the oil-seed market.

Speculation in bullion was controlled as from 29th May 1943, under a new Rule which prohibited forward contracts or option dealings in bullion. With a view to further curb speculative activities in bullion Government took powers under a new Rule to regulate advances against specified commodities particularly cotton and food-grains. Further, the period allowed for spot delivery of bullion was narrowed down to 2 days.

The Bombay Stock Exchange was also brought in line with other markets. All carry-forward business was prohibited and all transactions except for cash were banned.

As a result of the adoption of the above anti-speculative measures, the prices of various commodities considerably declined from the peak levels they had gone up in the early months of 1943.

(6) THE DEMONETISATION ORDINANCE AGAINST BLACK MARKETING :—In January 1946 the Government issued an Ordinance entitled the "*High Denomination Bank Notes* (*Demonetisation*) *Ordinance*" which was intended to deal chiefly with Black Marketing in the country. "The working capital of black market operations," stated an official announcement, "is believed to be held in a large measure in the form of

high denomination notes." High denomination notes were defined as Bank notes of the value of Rs. 500, Rs. 1,000 and Rs. 10,000. *These notes ceased to be legal tender after January* 12, 1946 (notwithstanding anything contained in section 26 of the Reserve Bank of India Act). The transfer and receipt of high denomination notes after the aforesaid date were prohibited.

The owners of these high denomination notes had to exchange them with smaller denomination notes at the Reserve Bank of India, or a Scheduled Bank or a Government Treasury, personally or by post before a specified date, after which they would *not* be accepted for exchange and would therefore be automatically not legal tender.

AS REGARDS EXCHANGE OF THE HIGH DENOMINATION NOTES :—It was notified that owners of such high denomination notes should within ten days after its commencement submit to the Reserve Bank or a Scheduled Bank or a Government Treasury with his application a *form of declaration* as prescribed therein in triplicate. The form demanded information as regards the name, status and address of the applicant, the circle of his income-tax assessment, the nature of his business and the partners, the salary of person, if salaried, and particulars of his employment, details of the denominational value of the notes tendered, the *reasons for their being so held*, and references to any other application made for exchange of high denomination notes. In order to ensure the identity of the owner who is to be the applicant, an attestation of the application by his banker or by a salaried magistrate or by a justice of the peace, or by a police officer not below the rank of inspector of police was prescribed. The penalty for false declaration or other contravention of the Ordinance was imprisonment up to three years, or fine or both.

Banks holding these high denomination notes were to exchange them with 100-rupee notes from the Reserve Bank of India.

At the instance of the Crown Representative practically all the Indian States had enacted legislation parallel to the British Indian Ordinance.

THE OBJECTS OF THE ORDINANCE :—In reply to a question in the Legislative Assembly, Sir Archibald Rowlands, the Finance Member, said that the objects of issuing the Ordinance were :—

(1) to strike at the black marketeers,
(2) to rope in the tax-dodgers,
(3) to deprive public servants who had betrayed their trust of some of their ill-gotten gains and to bring some of them to book,
(4) to check the unhealthy boosting of shares, which was taking place in certain sections of the market, to the enrichment of the speculator at the expense of the genuine investor,
(5) to bring under control a potential source of danger to sound monetary policy,
(6) to warn speculators, black marketeers, profiteers, the bribe-givers and the bribe-takers that, now that the war is over, Government intend to deal resolutely with them and to make it plain that Government will no longer tolerate their holding the community to ransom,
(7) to try and turn some of the hoarded money to *productive* use in the development of the country and lastly to fill in one of the many gaps in our statistical knowledge, and in this respect the ordinance is complementary to the analysis which the Reserve Bank is undertaking of bank deposits.

WERE THE OBJECTS FULFILLED ? :—The most vital requirement of this Ordinance was the statement of *reasons* by an owner for holding these high denomination notes. It is in this respect that the Ordinance aimed at detecting the black marketeer. The result of the Ordinance is not made public by the Reserve Bank of India and consequently it is not possible to know how many of these high denomination notes were set on fire by the black marketeer for fear of being hounded out by law.

(E) POST-WAR CONTROL OF PRICES :—In the post-war years the inflation outlook for India seems disquieting. There is no sign yet of the complete stoppage of further issues of Rupee-notes into circulation on the support of Sterling Securities created in favour of India. Thus the amount of notes in circulation has steadily increased from Rs. 1,157.03 crores in October 1945 to Rs. 1,241.94 crores on 10th May 1946, that is, a net increase of Rs. 84.91 crores to circulation since the closure of the war. Whereas, at the same time, investments in Sterling Securities which stood at Rs. 1,047.57 crores in October 1945 increased to Rs. 1,130.32 crores on 10th May 1946, that is, a net increase

of Rs. 82.75 crores. But it is somewhat heartening to note that since May 10, 1946, there is a downward trend in note circulation, whereas the investments in Sterling Securities have been kept steady. Unless, therefore, there is a dead-stop placed on the issue of notes into circulation, the inflationary trend is bound to continue to be dangerous.

(1) INCREASE IN CONSUMER GOODS :—It was stated previously that the mounting *excess* of purchasing power over dwindling supply of goods offered for sale was the prime cause of inflation. If this 'inflationary gap,' as this relation is called, is not eliminated by Taxation and Borrowing, prices must soar up, unless Statutory Price Control is imposed. Price Control must continue until the *supply of goods becomes equal to the demand for goods*. It is therefore essential to *increase the 'quantity of consumer goods* by encouraging domestic production and by increased imports to India, at the same time by stoppage of exports of consumer goods. Since the country's capacity to produce the numberless varieties of consumer goods required is extremely limited, as compared to the demand for such goods, the only hope rests in heavy imports. But civilian goods in foreign countries will continue to be scarce for a few years, and it would be difficult to purchase them in sufficient quantities for India, until the broken Continent is repaired ; at the same time people will have more expendable funds. If however the present Import Control is completely removed in the present heavy scarcity of consumer goods, and these goods are not imported in quantities large enough to flood the Indian market, they will simply be pushed on to feed the black markets. Consequently, effective control over the quantity, distribution, and prices of imported goods is a necessity. But a liberal policy of giving import licences must be immediately adopted to make the way clear for a stream of imports of consumer goods.

(2) STEADY DEFLATION :—Simultaneously with increase in the quantity of consumer goods, a policy of steady *deflation* of paper money should be applied by Borrowings. Unless the *excess* note issue is withdrawn from circulation, the 'inflationary gap' will not be narrowed and eventually closed. Such Borrowings must be at reasonably attractive rates and the policy pursued should not result in disturbance and do harm to the money market. When the entire economic structure of a country

is threatened by inflation, a vigorous deflationary policy is an all-out necessity. Under the circumstances, all other interests should be subordinated to this policy, and a loss of a small percentage in interest should be of little consequence to the Treasury.

The Borrowing Policy of the Government during 1946 has been based on their faith in "Cheap Money" policy. The rate of Borrowing has been reduced from 3½ per cent. to 2½ per cent., and 3½ per cent. Inconvertible Paper has been converted to 3 per cent. and 2¾ per cent. From the point of view of pure Public Finance, this policy may be applauded, for it reduces the Public Debt. For example, the total of new Securities issued at the new rate of 2½ per cent. and the conversion of 3½ per cent. Government Paper to 3 per cent. will give a saving in interest of nearly Rs. 1½ crores per annum. As against this saving to the Government, the losses inflicted on two most important financial constituents must be weighed, namely, (1) the Insurance companies and (2) the Banks.

Insurance companies are the largest single purchasers of Government Loans and therefore the best customers. By Act, Indian Insurance Companies are compelled to invest a certain minimum percentage of their funds in Indian Government Securities. Having made most of their investments in 3½ per cent. Government Paper, they now find themselves deprived of ½ per cent. by conversion of this Paper to 3 per cent., and they have in future to accept progressively lower rates of interest on Government Securities. It has, therefore, completely upset the long-term planning of the Life Insurance companies. This position must create uncertainty and fear in Insurance business. They have to struggle to exist between reduced incomes and increasing expenditure owing to rising cost of living. The banks too must suffer a loss in the matter of their investments in Government Securities. Government is therefore bound to lose lakhs of rupees in the form of income and super-taxes and they may come to find the balance-sheet going against themselves. If Insurance companies are compelled to shift the burden of reduced incomes on the policy-holders, their business will fall off ; which would again lead to lowering of incomes and the consequent loss to the Government.

But there is a more disquieting result of this Cheap Money Policy. The successive issues by Government of Loans at cheaper

rates have given a powerful stimulus to the boom on the Indian Stock Exchanges at present. Funds awaiting investment in Government Securities are being driven to feed the boom in shares which give far better returns than Government Paper. Far from checking this tendency severely in the days of inflation, Government Policy is responsible for creating further inflation in the share markets. Certain scripts, such as the Tata Iron and Steel shares, have touched high levels unknown in the history of the Indian Stock Exchanges.

(3) DEVELOPMENT EXPENDITURE MUST PROGRESS SLOWLY :—Yet another danger to the closing of the ' inflationary gap ' awaits the country. Heavy expenditure is to be undertaken in connection with the Development Plans in India. Vast funds will have to be borrowed for financing the expansion of industries and the planting of new ones. The immediate concern with us is : how to produce consumer goods so urgently required by the people. New industries must take sufficient time before they can produce consumer goods. The contemplated immediate development of roads, railways, electrical plants, etc., will prepare the ground for successful development of new industries ; they cannot produce consumer goods. But at the same time large sums will have to be spent on these developments in the beginning and such expenditures must result in increasing incomes and additional purchasing power. This must widen the ' inflationary gap.' If additional purchasing power is *superimposed* on the existing *excess* purchasing power, prices will be soaring upwards and the cost of living will be reaching destructive heights. The grip over Price Control will have, therefore, to be tightened all the time.

The absorption of a large part of the *excess* money in the purchase of capital goods for industries would be a very helpful step towards deflation, at least for two or three years. But the difficulties of purchasing capital goods in the near future from foreign countries, as mentioned previously, are immense.

As industrial development is inevitable in the years to come, a very cautious policy should be pursued. To state simply, if 100 units of money are pooled in by Borrowing in order to finance the Development Schemes, and say, 40 units of money are actually spent, then the resulting net deflation will be to the extent of 60 units of money. Spendings should be proportionately

much less than Borrowings. If such a scheme of Public Expenditure is followed, the present inflationary trend will be kept under control, and on the balance the much-needed deflation would tend to bring down prices. Let the enthusiasm for Developments not be carried too soon. Let the Plans, so to say, ' trot, not gallop,' otherwise the inflationary trend is quite ready to reach the highest heights.

(4) CONTROL RISING COSTS BY CONTROLLING COST OF LIVING :—A zealous watch is also necessary over rising costs in industries. If the rising trend in the cost of living, so alarmingly visible since May 1946, is not halted, still higher wages and salaries will have to be paid. If, further, the consequential rise in costs is not compensated for by expanding volume of production, the industries may be compelled to cut down their wages bill by cutting down shifts or partial closure of departments. Unless, therefore, their essential profits are safeguarded, production will be reduced and this would add to the calamity already produced by scarcity of essential goods. Government's control should be vigilantly focussed on the cost of living. Unbending control must be kept over prices of food, clothing, fuel and other essentials which enter into the cost-of-living index. It may be noted that in April 1943 the President of the United States of America issued an Order to " Hold the Line " in the country. This meant principally hold *wages rates* and *raw-material costs*. It is this " Hold the Line " policy which has concentrated the efforts of the Price Administration on the control of elements which entered into the cost of living of workmen and has formed the basis for price stabilization in that country.

(5) LARGE SUBSIDIES TO PRODUCERS OF ESSENTIAL GOODS :—In order to control the cost of living in India, all efforts should be centred on the *maximum* production of food-grains. Mere propaganda such as the ' Grow-More-Food ' campaign in an impoverished country is meaningless. Indian farmers, starving of essential necessaries and of means of production, must be fed with adequate *subsidies*. If Rs. 100 crores of Borrowed money were well and equitably distributed as subsidies to farmers to grow essential crops and these were to result in, say, 50 crores of maunds of food-grains, the *per capita* increase would be nearly $1\frac{2}{10}$ maunds per year, for a population of 45 crores. This estimate, although illustrative, points the way to future stabiliza-

tion of wholesale prices of food-grains and cost of living in India. Subsidies will help towards a successful policy of Government's monopolistic procurement of food-grains.

In Canada, the cost-of-living index has been practically kept stable since June 1942, from 117 in June 1942 to 118 in March 1945, and the variation was of 1 point only throughout this period. This was mainly achieved by the effect of Government subsidies upon prices, which is proved from the fact that the wholesale prices of farm products rose much less than the prices received by farmers.

In the United Kingdom, the cost-of-living index had been kept almost stable since January 1943. The cost-of-living index which was 129 in January 1943 stood at 131 in March 1945, the variation being of 2 points only. This was obtained by rigid Price Control, which covered practically all goods, and by means of *heavy subsidies* for essential goods and services entering into the index. The total amount spent on subsidies was £20 million in 1939, but in 1944 it was £220 millions. "Without these subsidies," said the Chancellor of the Exchequer in his Budget Speech, "the cost-of-living index might have been 45 to 55 per cent. over the pre-war level compared with the actual increase of 28 per cent."*

Similarly, in the United States of America from 1943 onwards, *subsidies* have been used extensively for the purpose of checking the rise in wholesale prices and the cost of living. "In October 1943," states the Compiler of the *World Economic Survey*, "the rate at which subsidies were being paid was equivalent to an annual outlay of $1,143 million. Foodstuffs and livestock accounted for 73 per cent. of the subsidies paid."† In Australia a general price ceiling for practically all goods and services was announced by the Government on April 12, 1943. Prices were *subsidized* at the level prevailing at that date. The pegging of prices did not mean that costs were also pegged. Costs had risen "and where the increases could not be absorbed by reducing the profit margins of the distributors, prices were kept down by the payment of *subsidies*."‡

If prosperous countries like the United States of America, the

* Reported in the London *Times* of 26th April 1944.

† League of Nations: *World Economic Survey*, 1942-44, page 237.

‡ *Ibid.*, page 239.

United Kingdom, Canada, Australia and others found the necessity for giving large subsidies for reducing wholesale prices and the cost of living, the case for giving subsidies to farmers, cottage weavers and other essential units in beggar-India is overwhelmingly strong. *Let us feed the farmer and he will feed us better and more cheaply.* Subsidies, it is truly said, never fail in their effects except by vicissitudes of weather or any other unforeseen factor. India's present and future price structure is mainly dependent on the domestic production of foodstuffs and cloth.

THE CONCLUSION :—Our conclusion is that for the stabilization of Indian prices the prime essentials are the following :—

(1) Immediately, *heavy subsidies should be given to farmers* for growing food-grains both on existing farms and on new ones. Similarly, *producers of cloth should be subsidized* adequately. The scale on which these subsidies should be given must be in amounts large enough to be distributed on a country-wide basis. To fight starvation, we do not require 'squads but armies.'

(2) A *steady Borrowing Programme* at rates unharmful to other financial constituents should be undertaken to bring about steady deflation and to feed the subsidies.

(3) *Statutory control over prices* should be rigidly continued on various essential goods, *until the total supply becomes equal to the total demand.*

CHAPTER XIII

The International Monetary Fund and the International Bank for Reconstruction and Development and India's Participation

(The Bretton Woods Agreement)

The United Nations Monetary and Financial Conference met at Bretton Woods, New Hampshire, and closed its session by July 1944. The 44 delegations, who participated in it, unanimously agreed to the text of two documents : (i) for setting up an International Monetary Fund, and (ii) for setting up an International Bank for Reconstruction and Development.

The Agreements were sent to the Governments for ratification, and it had been made clear that no Government was committed by the vote of its delegation at Bretton Woods. What had been decided was the form that these two institutions would assume when (or if) they came to birth.

1. OBJECTIVES OF THE PROGRAMME :—Mr. Henry Morgenthau, Jr. Secretary of the Treasury, United States of America, in his address at the closing Plenary Session of the Conference (July 22, 1944), presented a vivid picture of the objectives of the programme in order to establish the two international institutions. He said :—

"*A revival of international trade* is indispensable if full employment is to be achieved in a peaceful world, and with standards of living which will permit the realization of men's reasonable hopes. What are the fundamental conditions under which commerce among the nations can once more flourish ? First, there must be a *reasonable stable standard* of international exchange to which all countries can adhere without sacrificing the freedom of action necessary to meet their internal economic problems. This is the alternative to the desperate tactics of the past—competitive currency depreciation, excessive tariff barriers, uneconomic barter deals, multiple currency practices and unnecessary exchange restrictions by which governments vainly sought to maintain employment and uphold living standards.

In the final analysis these tactics only succeeded in contributing to world-wide depression and even war.

The International Fund agreed upon at Bretton Woods will help remedy the situation."

" Second, *long-term financial aid* must be made available at reasonable rates to those countries whose industry and agriculture have been destroyed by the ruthless torch of an invader or by the heroic scorched-earth policy of their defenders. Long-term funds must be made available also to promote sound industry and increase industrial and agricultural production in nations whose economic potentialities have not yet been developed. It is essential to us all that these nations play their full part in the exchange of goods throughout the world. They must be enabled to produce and to sell if they are to be able to purchase and consume.

The International Bank for Reconstruction and Development is designed to meet this end."

2. THE INTERNATIONAL MONETARY FUND :—It is necessary to give an account of this institution of world-wide importance.

SECTION I

Article I. *The Purposes of the International Monetary Fund*

The purposes of the International Monetary Fund, as set out in Article I of the approved Draft, were as follows : (1) To promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems. (2) To facilitate an expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high level of employment and real income and to the development of the resources of all members as primary objectives of economic policy. (3) To promote orderly exchange stability and exchange arrangements among members and to avoid competitive exchange depreciation. (4) To assist in the establishment of a multilateral system of payments in respect of current transactions between members, and in the elimination of foreign exchange restrictions which hamper the growth of world trade. (5) To give confidence to members to make the Fund's resources available to them under adequate safeguards, thus providing them with the opportunity to correct maladjust-

ments in the balance of payment without resorting to measures destructive of national or international prosperity. (6) To shorten the duration and lessen the degree of disequilibrium in the balances of payment of members.

Article II. *Conditions of Membership*

Article II sets the conditions of Membership. It provides that " the original member shall be those countries represented at the Conference whose Governments accept membership before December 31, 1945, and the membership shall be open to the Governments of other countries at such times and in accordance with such terms as may be prescribed by the Fund." The proposals drafted by the Conference will be submitted to the Legislative bodies of the countries represented for legal ratification. Agreement of delegates at the Conference to the Proposal does not bind their Governments.

Article III. *Allocation of the Quotas of Contributions to the Fund*

The total subscription to the Fund is $8,800,000,000 (corresponding to $10 million for the world as a whole). Both the subscriptions to be paid to the Fund and the right to draw upon the Fund's resources will be governed by a " quota " assigned to each country member.

The quotas for countries represented at the Conference are as follows :—

Country		Amount of Quota $
1.	The United States ...	2,750,000,000
2.	The United Kingdom ...	1,300,000,000
3.	Soviet Russia ...	1,200,000,000
4.	China	550,000,000
5.	France	450,000,000
6.	India	400,000,000
7.	Canada	300,000,000
8.	Netherlands	275,000,000
9.	Belgium	225,000,000
10.	Australia	200,000,000
11.	Brazil	150,000,000
12.	Czechoslovakia ...	125,000,000
13.	Poland	125,000,000
14.	Union of South Africa ...	100,000,000
15.	Other Countries ...	(Lower than) 100,000,000

(*a*) The figures of the Quotas are purely tentative and are mostly established on gold holdings and pre-war foreign trade. The National Income has also received consideration. In case of Russia and China quotas are based on *potential* post-war foreign trade. Intangible factor like economic significance was also taken into account in case of India and some other countries.

(*b*) *Other Members' Quotas*. The Plan provides further that the Quotas of other members shall be determined by the Fund at intervals of five years' review.

(*c*) *Change in Quotas*. The Quotas may be revised from time to time but changes shall require a *four-fifths vote* and no member's quota shall be changed without the consent of the member concerned.

(*d*) *Obligatory Gold*. The obligatory gold subscription of a member country shall be fixed at (i) 25 per cent. of its quota, or (ii) 10 per cent. of its net official holdings of gold and United States Dollars as at the date the Fund notifies members that it will shortly be in a position to begin exchange transactions.

Each member shall pay the balance of its quota in its own currency. It also provides for an alternative gold figure agreed to by the Fund in the case of countries which, by reason of enemy occupation, cannot determine gold holdings accurately.

(*e*) *Executive Directors*. That *five* Executive Directors should be allocated to the countries holding the *highest* quotas, namely, the United States, the United Kingdom, Russia, China and France. (See Article 12 for further details.)

(*f*) 50 per cent. of the gold earmarked for the Fund will be stored in the United States, and 40 per cent. will be stored in the United Kingdom, Russia, China and France, and the remaining 10 per cent. will be allocated between the other member states.

(*g*) Voting power in the Fund would be closely related to Quotas.

Article IV. *Par values of the Currencies of Members*

The Plan provides that *the par value of the currency of each member shall be expressed in terms of gold as a common denominator, or in terms of the United States dollar of the weight and fineness in effect on July* 1, 1944.

(i) All transactions between the Fund and the members shall be *at par* subject to a *fixed charge* payable by the member making application to the Fund, and all transactions in member currencies shall be at rates *within an agreed percentage* of parity.

(ii) The Plan provides machinery for changing a par value of a member's currency (*a*) only on the proposal of a member and (*b*) only after consultation with the Fund.

(iii) *The Plan allows for an initial* 10 *per cent. increase in par value to which the Fund shall raise no objection.* In case of application for a further increase, not covered by the above, and not exceeding 10 per cent., the Fund shall give its decision within 72 hours.

(iv) An agreed uniform *change* may be made in the gold value of member currencies, provided *every* member country having 10 per cent. or more of the aggregate quotas approves.

(v) Member countries agree *not to propose a change in* the parity of their currency *unless they consider it appropriate to the correction of a fundamental disequilibrium*. Changes shall be made only with the approval of the Fund and subject to the above provisions. The Fund, however, shall *not reject* a requested change, necessary to restore equilibrium, because of

the domestic, social or political policies of the country applying for a change.

(vi) It also outlines penalties for unauthorized changes in par value by a member. The sanctions which can be evoked are ineligibility to use the resources of the Fund, or in certain cases expulsion from membership.

SECTION II

Gold purchase based on par values. The Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin, or sell gold at a price below par value minus the prescribed margin.

SECTION III

Foreign exchange dealings based on parity. The maximum and minimum rates for exchange transactions between the currencies of members taking place within their territories shall not differ from their parity, (i) in the case of spot exchange transactions, by more than 1 per cent. and (ii) in the case of other exchange transactions, by a margin which exceeds the margin for spot exchange transactions by more than the Fund considers reasonable.

Article V. *Transactions with the Fund*

This Article sets the methods of conducting transactions with the Fund. It states :—

(i) Each member shall deal with the Fund only through its Treasury, Central Bank, Stabilisation Fund or other similar fiscal agency, and the Fund shall deal only with or through the same agencies.

(ii) A member shall be entitled to *buy* another member's currency from the Fund in exchange for its own currency on the following conditions :

(*a*) that it is needed to make payments in that currency which are consistent with the purposes of the Fund ;

(*b*) that the Fund has not given notice that its holdings of the currency demanded have become scarce ;

(*c*) that the Fund's total holdings of the currency offered have not been increased by more than the required percentage (25 per cent.) of the member's quota during

the previous twelve months and do not exceed 200 per cent. of the quota.

(iii) The operations of the Fund will be limited to transactions for the purpose of supplying a member country on the member's initiative with another member's currency in exchange for its own currency or for gold.

(iv) This Article also sets up a system of sliding scale charges which the Fund may levy against members, based on the average daily balance of its currency held by the Fund in excess of the member's quota. The charges are payable in gold.

(*a*) A non-recurring service charge of ¾ per cent. is to be levied, and (*b*) in addition a system of recurring charges, analogous to interest, varying with the amount and with the duration of the accommodation provided. These charges rise gradually from ½ per cent. to 5 per cent., after which they can be made penal.

These charges go into the general income of the Fund, and if any distribution is made, the first slice is to pay 2 per cent. per annum to the surplus countries on the amount of their currencies provided to the deficit countries. In addition, on some crucial issues, voting power is to be taken away from deficit countries and given to surplus countries.

The levying of these charges, however, is an important part of the Fund's operation, since the amounts involved are sizeable and are designed to discourage continuing unbalanced trends of currencies flowing into the Fund.

Article VI. *Capital Transactions*

This Article makes it *impossible* for a member to use the Fund "to meet a large or sustained outflow of capital." The Fund may require a member country to exercise controls to prevent such use of the reserves of the Fund. This provision is not intended to prevent the use of the Fund's resources for capital transactions of reasonable amount required for the expansion of exports or in the ordinary course of trade, banking or other business. A member country may not use its control of capital movements to restrict payments for current transactions or to delay unduly the transfer of funds in settlement of commitments.

Article VII. *Apportionment of Scarce Currencies*

(i) This Article is devoted to the control of scarce currencies in the Fund. If the Fund finds that a general scarcity of a

particular currency is developing, the Fund shall so inform member countries and propose an equitable method of apportioning the scarce currency. The Fund shall issue a report embodying the causes of the scarcity and containing recommendations designed to bring it to an end. A representative of the member whose currency is involved shall participate in the preparation of the report. The decision by the Fund to apportion a scarce currency shall operate as an authorisation to a member country, after consultation with the Fund, temporarily to restrict the freedom of exchange operations in the affected currency, and in dealing with the manner of restricting demand and rationing the limited supply among its nationals, the member country shall have complete jurisdiction.

(ii) The Fund may, if it deems necessary, take action to replenish its holdings of any member's currency, and take either or both of the following steps :

(*a*) Propose to the member that the latter lend its currency to the Fund or that, with the approval of the member, the Fund borrow such currency from some other which is prepared to make such loans to the Fund or to approve the borrowing of its currency by the Fund from any source.

(*b*) Require the member to sell its currency to the Fund for gold.

Article VIII. *General obligations of Fund members*

This Article sets forth the general obligations of Fund members (i) to avoid restrictions on currency payments, (ii) to avoid discriminatory currency practices, and (iii) to agree to the furnishing of whatever information the Fund may require for its operations, e.g. every information regarding holdings of gold and foreign exchange at home and abroad, trade and investment figures, domestic and foreign exchange controls, buying and selling rates for foreign currencies and details of clearances and so on, (iv) not to buy gold at a price which exceeds the agreed parity of its currency by more than a prescribed margin and not to sell gold at a price which falls below the agreed parity by more than a prescribed margin.

Article XII. *Management*

1. The Article provides that the Fund shall be governed by a Board of Governors which shall consist of one governor and

one alternate appointed by each member to serve for 5 years but to be eligible for reappointment. The Board shall meet at least annually. There shall be not less than 12 Executive Directors (who need not be Governors), 5 of these shall be appointed by the 5 members with the largest quotas, 2 shall be elected by the American Republics not entitled to appoint Directors, and 5 shall be appointed by other members not entitled to appoint Directors. The Executive Directors shall function in continuous session. They shall elect a Managing Director who shall not be a Governor or an Executive Director.

2. Election is to be by proportional representation. Each member shall have 250 votes, plus one additional vote for each part of its equivalent to 100,000 United States dollars.

Article XIII. *The Offices*

The principal office of the Fund shall be located in the territory of the member having the largest quota, and agencies or branch offices may be established in the territories of the other members.

Article XIV. *Transitional Arrangements*

The Fund will come into being before the end of 1945; and the transitional period will last for five years from then, that is to say, after five years the Fund may require a member, without its consent being necessary, to abandon such restrictions on current transactions as are allowed in the interim. During the interim period exchange controls are still to be permitted. But after the war, members shall undertake to withdraw as soon as possible by progressive stages any restrictions which impede multilateral clearing on current account.

Article XV. *Withdrawal*

This Article recognises the right of members to withdraw at any time from the Fund by giving notice in writing. It also traces in technical detail the settlement of accounts with members withdrawing with reasonable dispatch, and by agreements between the member and the Fund.

Article XVI. *Emergency Provisions*

This Article is devoted to emergency provisions the most important of which is that the Executive Directors by unanimous

vote may suspend for a period of not more than 120 days the operation of the Fund.

Article XVII. *Amending the Fund*

This Article sets a method of amending the Fund plan when 3/5ths of the members, having 4/5ths of the total voting power have accepted an amendment.

Article XX. *Agreement to come into force*

This Article establishes that Agreement shall enter into force when it has been signed on behalf of Governments having 65 per cent. of the total quotas but in no event before May 1, 1945.

3. VALUE OF THE INTERNATIONAL MONETARY FUND :—In winding up the final plenary session of the Bretton Woods Conference, Mr. Henry Morgenthau, Jr., claimed that they had succeeded in working out a scheme which would do away with the economic evils of competitive currency devaluation, and that extreme economic nationalism belonged to an era which was dead, and that the Conference had devised machinery by which men and women could freely exchange the products of their labours on a fair and stable basis. Earlier he stated : "Unless we agree to expand world trade and develop the world economy, few other economic agreements which we might make will or can be effective."* If economic prosperity is to be restored in the war-torn world, international trade must be made to prosper. A prosperous international trade will create a high level of employment and will better the standard of living in various countries. It will give bread and more bread to the millions who have been made to starve by the ravages of the global war.

(1) A SELLING INSTITUTION OF WORLD'S CURRENCIES :—The International Monetary Fund is a machinery which will contribute towards this prosperity by helping countries *to maintain reasonable stability in exchange rates.* The Fund is a *reservoir* of world's currencies from which a *debtor country* may *purchase the currency of its creditor country in exchange for its own currency or for gold, when it does not possess the latter country's currency.* In the absence of such a ready

* *Federal Reserve Bulletin*, May 1944, page 436 His statement before Committees of the Senate and the House of Representatives on April 21, 1944.

facility, the debtor country may be forced to depreciate its currency or to place exchange restrictions, or take other means, if it cannot pay the creditor country in goods or services. The Fund, therefore, plays the part of a corrective and prevents a debtor country from undertaking any measure which is destructive of national or international prosperity. The Fund is *not a lending body* but a *selling body* of world's currencies. *By selling a particular currency to a debtor country needed by it, the Fund gives it immediate liquidity and helps it to tide over the difficult situation smoothly*. Consequently, the debtor country gets some breathing time to correct the maladjustment in its balance of payment with the creditor country. The existence of the Fund ought automatically to prohibit a debtor country from manipulating its currency or imposing controls, for the Fund will help to give stability to its currency in conducting her current foreign trade transactions.

The Fund is a stockist ready to sell a particular currency to a debtor country only under two conditions : (i) that it is needed to make payments in that currency " which are consistent with the purposes of the Fund " (stated in Article I), and (ii) that the amount of the currency that it needs does not exceed the prescribed limits set in Article V ; that is, (*a*) in any one year a country may purchase from the Fund an amount of foreign currency not exceeding 25 per cent. of its quota, and (*b*) the *total amount* of foreign currency which a country may buy from the Fund over a period of years is limited by the provision according to which the Fund's holdings of any member country's currency shall not exceed 200 per cent. of that country's quota. These limitations empower the Fund to keep a disciplinary and watchful eye over the foreign trade and other transactions of a debtor country. If a debtor country by purchasing a certain currency, is exhausting its quota rapidly to the extent that it is nearly reaching the prescribed upper limit, it would indicate the existence of a vital disequilibrium with the creditor country. It would at once induce the Fund to demand from the debtor country every information regarding its economic position (under Article VIII) and at the same time to give advice and to act as a mediator, in order to enable it to improve its increasingly indebted position with the particular creditor country. The Fund would use as much pressure on the debtor country to set

right the disequilibrium factors as it would use its moral influence on the creditor country to give temporary relief to the former.

(2) THE CONTROLLER OF PAR VALUES OF CURRENCIES :—The Fund provides, in Article IV, machinery for changing a par value of a member's currency (*a*) only on the proposal of a member and (*b*) only after consultation with the Fund. But it also *allows for an initial* 10 *per cent. increase in par value* to which the Fund shall raise no objection, and thereby provides a certain degree of elasticity. It stipulates that no member country shall propose a change in the parity of its currency unless it considers it appropriate to the "*correction of a fundamental disequilibrium.*" Such a change shall be made only with the approval of the Fund which will give its sanction only if it were essential to correct a fundamental disequilibrium. While at the same time, the Fund will not interfere with the domestic, social and political policies of the country applying for a change. It will however, be an advisory body.

On the contrary, if a member country goes wrong and makes unauthorised changes in par value, sanctions will be invoked against it as a penalty, which will make the country ineligible to use the resources of the Fund or it may be expelled from membership. "Having studied the world picture," stated Mr. Henry Morgenthau, "after the last war, we are all agreed that an effort must be made to prevent in so far as possible, harmful fluctuations of currency; and to prohibit deliberate manipulation of currencies in an effort to secure unfair competitive advantage in world trade."*

The Fund is a means to attain these objectives.

(3) IT PROVIDES A MEASURE OF FLEXIBILITY OF EXCHANGE RATES :—Further, the Fund assures a measure of exchange flexibility by providing that member countries are free to regulate separately for themselves the range of their exchange rates *within* the maximum and minimum limits prescribed by the Fund (in Article IV).

(4) EQUITABLE APPORTIONMENT OF SCARCE CURRENCIES :—For the same purpose of promoting stability in exchange rates, the Fund will take steps to apportion equitably Scarce Currencies among the member countries. When it

* *Federal Reserve Bulletin*, May 1944, page 436.

becomes evident to the Fund that the demand for a member country's currency may soon exhaust the Fund's holdings of that currency, the Fund shall so inform member countries and propose an equitable method of apportioning the Scarce Currency. When a currency is thus declared scarce, the Fund shall issue a report embodying the causes of the scarcity and containing recommendations designed to bring it to an end [Article VII (i)].

Further, the same Article provides that the decision to apportion a scarce currency shall operate as an authorization to a member country, after consultation with the Fund, temporarily to restrict the freedom of exchange operations in the affected currency and in determining the manner of restricting the demand and rationing the limited supply among its nationals, the member country shall have complete jurisdiction. The Fund may also, if it deems necessary, take action to replenish its stock of any member's currency by borrowing it from a member or purchasing it from it for gold.

(5) IT IS NOT THE GOLD STANDARD :—The Fund assigns to gold a very important role. It provides that the par value of the currency of each member country shall be expressed in terms of *gold* as a common denominator. But this does not mean that it is an attempt to restore the old Gold Standard. In the first place, the Fund prescribes the obligatory gold subscription by a member country which enables the Fund to pool a substantial part of world's gold, at the expense of the member countries. Secondly, the provisions in Article V (vi) stipulate that if a member country's national gold holdings are in *excess of its quota*, the Fund in selling foreign exchange to that country may require it to pay for *one-half of the net sales in gold thereby forcing it to part with a portion of its national gold holdings*. Besides, if a member country's national gold holdings have *increased* at the end of a financial year, it may be required by the Fund to *repurchase* part of the Fund's holdings of its *currency* up to *one-half of the increase in its national gold holdings*. In essence, the Fund would pick up one-half of the increase in a country's national gold holdings and thereby *deprive this part of the gold from forming a basis for extension of its credit structure*. If an increase of gold within a country automatically leads to an expansion in its credit structure, we

are within the orbit of the Gold Standard. But the Fund will not permit this to happen at certain times and beyond certain limits. It therefore *takes away an important* essential of the *Gold Standard*, which is to link the domestic credit structure to the volume of gold within a country. Further, the Fund safeguards against a member country's excessive gold hoarding by insisting on a uniform change in gold's currency price. Thirdly, in the Gold Standard the links established between the gold currencies are perfectly rigid as the mint pars are fixed. But the Fund gives some elasticity by (i) providing for changes in rates of exchange within certain limits, and (ii) in providing for accommodation to member countries with adverse balance of payments. Indeed the object of the Fund is the same as that of the Gold Standard, namely, to secure (i) universal convertibility of currencies and (ii) maximum stability of the value of currencies. But the means adopted are different.

4. INDIA'S CASE BEFORE THE BRETTON WOODS CONFERENCE :—The Delegation from India consisting of (i) Sir Jeremy Raisman, the Finance Member (Leader), (ii) Sir Chintaman D. Deshmukh, Governor of the Reserve Bank of India, (iii) Sir Theodore Gregory, Economic Adviser, and two non-officials, (iv) Sir R. K. Shanmukham Chetty and (v) Mr. A. D. Shroff, with Mr. Madan of the Reserve Bank as the Secretary, attended the International Monetary Conference at Bretton Woods. The Indian Delegation worked in complete harmony and were agreed on all the fundamental points affecting India, which they placed forcibly before the Conference, but regarding which they returned disappointed.

They pleaded unsuccessfully :

(i) for raising the quota of India so as to enable her to get a permanent seat on the Executive Membership ;

(ii) for bringing within the scope of the Fund the question of the orderly liquidation of abnormal war-time balances ; and

(iii) for incorporation in the functions of the Fund special assistance to backward countries like India and China for their economic development.

We shall deal with each of these : —

(i) SUITABLE QUOTA FOR INDIA AND A PERMANENT SEAT ON THE MANAGING BODY :—The Delegation pleaded

that India should have a larger quota on account of its relative economic position. The larger quota was important because it would give (*a*) India a permanent seat on the Managing Body and (*b*) determine the amount of foreign exchange, especially dollars it can buy per year from the Fund, and India's special creditor position entitled her to buy increasing foreign exchange. The reservations made by the Delegation were, however, withdrawn when the draft plan for the Fund came up for final consideration before the Conference. The United States of America in the first stage opposed the increase in the quota of India with a view to enabling India to have a seat on the Managing Body, on the ground that the inclusion of two permanent members from the British Empire countries would be misunderstood by the American public, probably because of the weightage it would give thereby to the British Empire on the Managing Body of the Fund. Sir Jeremy Raisman on behalf of the Indian Delegation observed : " It is not only a question of India's size nor alone of her population, but that on purely economic criteria India is an important part of the world and will be an even more important part in the years to come. India is not disposed to argue about the absolute size of the quota in the manner in which some other countries might wish to do. She is more concerned about her relative position among the countries that form the general set-up of the Fund . . . that it is not only a question of the quota but it is the arrangements relating to the management of the Fund that are our concern."*

But in the American view, as expressed by Mr. Harry White, the Indian quota as finally determined by the Quota Committee of the Conference, was based on " due recognition of India's economic significance," as was arrived at in the case of every other country. However, Sir Shanmukham Chetty, on his return to India from the Conference, stated : " It was our contention that if purely economic reasons are applied, as it was originally intended, India must get a higher place, but unfortunately political considerations prevailed and it is purely on this consideration that India was excluded "† (from becoming a member of the Executive Directorate of the Fund). In the first stage, then, India lost the chance of being *appointed* among the

* Report of the Indian Delegation, pages 18 and 19.

† In his statement to the Representative of the *Times of India*.

5 members on the Executive Directorate by the 5 members with the largest quota, as her quota has been the 6th in order of merit. But her hope rested in being "*elected* by the remaining members." In his address to the Bombay Rotary Club in October 1944, Sir Chintaman Deshmukh made the interesting disclosure that the Indian Delegation were able to secure a quota "sufficiently large to ensure a seat for us in every election without any outside support. Thus the conclusion might be regarded as meeting all our legitimate aspirations but not satisfying our national dignity."

The report of the Indian Delegation (page 20) explains the rules relating to election of Executive Directors. The procedure prescribed is clumsy but the Report makes the emphatic pronouncement that "on the least favourable assumption made above (that no other country votes for India in any ballot) therefore, the election of India to the Executive Directorate under the present rules and the present distribution of quotas is assured."

However, as matters have turned out, owing to the fact that Russia has declined to join as an original member, India has become one of the "Big Five" in the Fund and the Bank, and as such has become an appointed and not an elected Member of the Directorate.

(ii) LIQUIDATION OF WAR DEBTS (STERLING BALANCES) :—We have already dealt with the subject of liquidation of the Sterling Balances in Chapter XI to which reference is made.

(iii) DEMAND FOR FUND'S SPECIAL ASSISTANCE TO ECONOMICALLY UNDERDEVELOPED COUNTRIES :—Another amendment presented by the Delegation was regarding special help which the Fund ought to give to economically underdeveloped countries like India and China. Before the Drafting Sub-Committee Sir Shanmukham Chetty explained the implications of the Joint Statement presented by the United Kingdom and the United States, which mentioned that the Fund will be guided in all its decisions by one of its purposes "to facilitate the expansion and balanced growth of international trade and to contribute in this way to the maintenance of a high level of employment and real income, which must be a

primary objective of economic policy."* He explained that phrases like "full employment" and "the maintenance of real income" made small appeal to the vast populations of Eastern countries like India and China, which had yet to attain minimum standards of living before they could maintain them, and which looked to the development of their resources rather than to "full employment," ordinarily so understood, as their broad economic objective. But the amendment was opposed on two grounds :—

(*a*) It was pointed out that it went beyond the scope of the Fund and introduced objectives which were germane to its main purpose. That the Fund "aimed at the short-term objective of the maintenance of exchange stability and the promotion of international trade thereby, while the utilization of the resources of underdeveloped countries was a long-term objective which could not properly be achieved through its instrumentality."*

(*b*) The United States and United Kingdom delegates regarded the objective of levelling up of economically underdeveloped countries as belonging more appropriately to the functions of the other international institution proposed to be set up, namely, the International Bank for Reconstruction and Development.

5. THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT :—The Bretton Woods Conference also approved the final draft Agreement for the establishment of the International Bank whose activities are to be devoted to reconstruction and development.

Here again it is specified that the Agreement shall become valid when it has been signed on behalf of the Governments whose minimum subscriptions are not less than 65 per cent. of the total subscriptions of the nations at the Conference.

A. THE PURPOSES OF THE INTERNATIONAL BANK : The first Article sets out its purposes. These are :—

1. To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes including (*a*) the restoration of economies destroyed or disrupted by war, (*b*) the reconversion of productive facilities to peace-time needs, and (*c*) the encouragement of the

* Report of the Indian Delegation to the United Nations Monetary and Financial Conference at Bretton Woods, page 12.

development of productive facilities and resources in less developed countries.

2. *To promote private foreign investment* by means of (*a*) *guarantees* or (*b*) *participations* in loans and other investments made by private investors, and (*c*) to supplement private investment when private capital is not available on reasonable terms by providing on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources.

3. *To promote the long-range balanced growth of international trade* and the maintenance of *equilibrium* in balances of payments by encouraging long-term international investment thereby assisting in raising productivity, the standard of living and conditions of labour in their territories.

4. To encourage loans made or guaranteed so that the more useful and urgent projects, large and small alike, will be dealt with first.

5. To conduct its operations so as to bring about a smooth transaction from a war-time to a peace-time economy.

B. MEMBERSHIP :—The original members of the Bank shall be those members of the International Monetary Fund which accept membership in the Bank, and other members may be admitted later by the Bank.

C. CAPITAL STOCK :—(1) The Bank shall have an authorised capital of 10,000 million in terms of United States Dollars of the weight and fineness in effect on July 1, 1944, divided into 100,000 shares of 100,000 Dollars each available for subscription only by members. The capital may be increased by a three-fourths majority of the total voting power.

(2) The original members shall subscribe the *minimum* number of shares of the Bank (set forth in Schedule A), totalling 9,100 million, the remaining portion of the capital stock being reserved for subscription by other members.

(i) The distribution of share capital among countries is approximately the *same* as that of the quotas under the Fund, the only changes from the quota distribution under the Fund in respect of the first 14 countries being that the subscriptions of United States, China and Canada are higher by 425 million, 50 million and 25 million respectively, while the subscription of Brazil is lower by Dollars 45 million than their corresponding Fund quotas.

(ii) The subscription of each member country will be divided into two parts :

(*a*) 20 per cent. will be paid up, of which 2 per cent. will be in gold and 18 per cent. in local currency. This amount (20 per cent.) will be utilized to enable the Bank to make *direct loans* out of its share capital.

(*b*) The remaining 80 per cent. will be called only when required to meet any obligations arising from the *other two kinds of loans* with which the Bank will be concerned, namely, (i) loans made by the Bank out of funds raised by the Bank in the *market*, and (ii) loans made by private investors with the *guarantee* of the Bank. On these two types of loans the Bank will charge a commission of 1—1½ per cent. per annum, which will be set aside as a reserve to meet any losses that may arise through default or otherwise. It is only when the reserve is not sufficient to meet such losses that the unpaid balance (80 per cent.) of the Bank's share capital will be drawn upon.

D. PROVISIONS RELATING TO LOANS AND GUARANTEES :—(*a*) It may be re-stated that the Bank (i) will make direct loans or participation in loans out of its *own funds*, (ii) will make loans or participate in loans out of funds raised by the Bank in *the market*, and (iii) will guarantee loans made by private investors wholly or in parts. The total amount of all these three must not exceed the total of the Bank's share capital and reserve funds.

(*b*) All loans made or guaranteed by the Bank must be guaranteed by the Government, Central Bank or some comparable agency of the borrowing country.

(*c*) Except in special circumstances, loans shall be for the purpose of specific projects of reconstruction or development.

(*d*) The Bank will give its assistance only to projects that have been recommended by a competent committee of the Bank, after careful study of the merits of each proposal.

(*e*) For the Bank to make loans to members it must be satisfied that the borrowers would be unable to obtain a loan otherwise under reasonable conditions.

E. PROVISIONS REGARDING CURRENCIES :—There are detailed provisions included in the statutes dealing with the availability and transferability of currencies. These make it incumbent on the Bank to receive from and pay to various members the currencies needed by them. In the normal course, the Bank shall furnish the borrowing member with such currencies of *other* members as are needed for expenditure in their territories. Provisions are, however, made to meet exceptional circumstances.

F. ORGANIZATION AND MANAGEMENT :—Many of the provisions in regard to organization and management of the Bank are similar to those in respect of the Fund and reference is made to them. However, to summarize them, the Bank shall have a Board of Governors, Executive Directors, a President and staff. The Board of Governors shall consist of one Governor and one alternate appointed by each member to serve for five years but to be eligible for reappointment. The Board shall at least hold an annual meeting. Each member shall have 250 votes plus one additional vote for each share of stock held. The Executive Directors shall be 12 in number who need not be Governors and of whom 5 shall be appointed by the 5 members having the largest quota and 7 shall be elected by the remaining members ; they shall be appointed or elected every two years. Each Director shall appoint an alternate with full power to act for him when he is not present. There shall be an Advisory Council to advise the Bank on matters of general policy, of not less than 7 persons selected by the Board of Governors to represent various interests. The Council shall meet at least once a year. The principal office of the Bank shall be located in the territory of the member holding the largest number of shares.

G. WITHDRAWAL FROM MEMBERSHIP :—Any member may withdraw from the Bank at any time by transmitting a notice in writing to the Bank, the withdrawal being effective when such notice is received. There are provisions for suspension of membership and compulsory withdrawal by a member after a period of suspension.

Any member which ceases to be a member of the International Monetary Fund shall automatically cease after three months to be a member of the Bank, unless the Bank by a three-fourths of the total voting power has agreed to allow it to remain a member.

6. VALUE OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT :—We would not rehearse once again the purposes of the International Bank but there are certain features which need emphasis. In the first place it should be made clear that it is *not* the function of the Bank to participate in the operations of " Relief and Rehabilitation " which are taken up by the United Nations Relief and Rehabilitation Administration (UNRRA) which was set in November 1943. The main function of the UNRRA is " to open, co-ordi-

nate, administer or arrange for the administration of measures for the relief of *victims of war* in any area under the control of the United Nations through the provision of food, fuel, clothing, shelter and other basic necessities, medical and other essential services ; and to facilitate in such areas, so far as necessary to the adequate provision of relief, the production and transportation of these articles and the furnishing of these services."* The scope of the operations of the UNRRA is clearly limited and is of a short-term duration. On the contrary, the aim of the International Bank is to be a financing machinery for reconstruction and development both of which are productive operations of a long-term character.

Essentially it is a Bank of *guarantee*. As provided for in section (D) above, the Bank will make direct loans to members out of its own stock only if it is satisfied that the borrowers would be unable to obtain a loan from a private or public lending body under reasonable conditions. The Bank will make loans only in the last resort and that too to the extent of 20 per cent. of the stock only. It is, therefore, designed to promote private foreign investment by guaranteeing issues made by private investors. We may quote Mr. Henry Morgenthau, Jr., Secretary of the Treasury, who stated in outlining his proposal : "The primary aim of such an agency should be to encourage private capital to go abroad for productive investment by sharing the risk of private investors and by participating with private investors in large ventures. The provision of some of the capital needed for reconstruction and development, where private capital is unable to take the risk, is intended to remain secondary in the operations of such an agency. It should, of course, scrupulously avoid undertaking loans that private investors are willing to make on reasonable terms. It should perform only that part of the task which private capital cannot do alone."† Further, the guarantee of the Bank will be a powerful factor to induce otherwise nervous private investors to lend large sums to countries which in their opinion are not considered safe enough to be lent on their own merits. It would greatly expand the sphere of private lending by

* *World Economic Survey*, 1942-44, page 55.

† In his Foreword to the Preliminary Draft Outline of a proposal for a Bank for Reconstruction and Development of the United and Associated Nations issued in November 1943.

enlarging the volume of international investment and would act as an enormously effective stabilizer and guarantor of loans which they might make.

Long-term financial assistance must be made available at reasonable rates to those countries whose economies have been destroyed by the war. Their agriculture and industries must be restored to normality in order that their peoples may get employment as well as bread and they may settle down to their normal business life. They must be enabled to produce commodities and sell them to other nations so that they can purchase those they urgently require. It is important also to help partially developed countries to increase their economies as fully as possible so that they can play an adequate part in the development of international trade. In either case, if granting of a loan helps a country to develop its productive resources it would increase its purchasing power, raise the standard of living of its people and create a new market for other countries. In this way both lending and borrowing countries will share in growing prosperity and lay the foundation for a steadily growing international trade; and as Lord Keynes claimed, "the Bank would promote world economic expansion as directly opposed to inflation."

7. INDIA'S PARTICIPATION IN INTERNATIONAL MONETARY FUND AND THE INTERNATIONAL BANK :— The question of India's adherence to the Bretton Woods Agreements came up before the Central Legislative Assembly on January 29, 1946. It may be noted that, before the Legislative Assembly met, the Government of India had provisionally accepted the Bretton Woods Agreements. We have detailed in Chapter XI that the Legislative Assembly appointed a Committee to go into this question. The Committee submitted the Interim Report which was approved by the Legislative Assembly on March 1, 1946, without a division. As a consequence, India was represented in the first meetings of the International Monetary Fund and the International Bank for Reconstruction and Development in Washington, and Sir Chintaman Deshmukh, Governor of the Reserve Bank of India, was deputed to be the first Governor to represent India on the two institutions.

The adherence to the Bretton Woods Agreements was, however, conditional. It rested entirely on the fate of the Sterling

Balances. The final decision whether it would be to India's advantage to remain a member of the Bretton Woods institutions would depend, according to the Report adopted by the Legislative Assembly, (i) on the negotiations between India and Great Britain for the liquidation of the Sterling Balances, which should be opened without the least possible delay, (ii) on whether the settlement of the Sterling Balances are satisfactory to India or not, and (iii) on an early reassurance on the part of the British Government that in the meantime the Sterling Balances would not be scaled down.

There was also the stipulation that no further financial commitments should be undertaken by Government with regard to the Fund and the Bank before the matter had been further considered by the Committee. The Committee should be summoned to have a report from the Governor on his return from the first meetings of the Board of Governors of both the Fund and the Bank.

However, it was during the autumn session, on the 28th October 1946, that the Central Legislative Assembly passed *unanimously* the motion of Mr. Liaquat Ali Khan, the Finance Member of the Interim Government, approving India's *continued* membership of the International Monetary Fund and the International Bank. The previous condition, that unless the question of the Sterling Balances was settled there would be only temporary adherence, was waived ; and India joined the two institutions 'on merit.' In winding up the Debate Mr. Liaquat Ali Khan said, "Since the complexion of the Government of India has changed, the attitude of His Majesty's Government has also undergone a change, and they are today anxious to start these negotiations with regard to our Sterling Balances."

8. DISTINCT ADVANTAGES TO INDIA :—Assuredly, all public effort in India should be focussed on the liquidation of the Sterling Balances. Let us, however, not lose sight of the obvious advantages that India will gain by joining the Fund and the Bank.

Firstly, the Fund will provide India with all sources of foreign exchange, particularly those hard currencies such as the Dollar, which the country needs so urgently for purchase of capital goods for rapid industrialization. Similarly, the Bank would be a great

asset to India in obtaining the much needed long-term finance for productive investment. Secondly, the Fund will give to *Non*-Sterling Area countries access to Rupees to purchase Indian commodities. This will enable India to have more diversified and less 'chained' export markets. Thirdly, as an original member, India is a member of the Executive Directorate and would thus be in a position from the start to guide the policies which would determine the actions of the Fund and of the Bank in the future. Fourthly, by adhering as an original member, "India undoubtedly would enhance her ever-growing international status and prestige, and by her action would avoid the risk of arousing resentment in America, where the administration and the public had warmly supported the Bretton Woods Agreements, particularly at a time when India had a great deal to do with the United States in the future."*

* Sir Archibald Rowlands, the Finance Member, in his speech initiating the Debate in the Central Legislative Assembly on January 25, 1946.

CHAPTER XIII (A)

The Rupee Linked with International Standard

(April 8, 1947)

April 8, 1947, will rank as a landmark in the history of the economic independence of India. On this day the Central Legislative Assembly gave assent to the Bill presented by Mr. Liaquat Ali Khan, the Finance Member, to break the statutory link between the Rupee and Sterling. It was a natural consequence of India becoming a member of the International Monetary Fund. It was noted before that in this Fund members were required to express the par values of their currencies in terms of *gold*, and exchange rates were to be determined by the ratios, which the par values so expressed to member currencies, bore to each other. As a result, the continuance of a *direct* statutory link with the Sterling, which is provided for by Sections 40 and 41 of the Reserve Bank of India Act, becomes both unnecessary and inappropriate.

Consequently, these Sections 40 and 41 are repealed and they are replaced by others designed *to link the Rupee to currencies of all those countries who are members of the International Monetary Fund.* It would be *no longer compulsory* on the Reserve Bank of India to buy and to sell Sterling in Rupees at certain fixed rates without limit of amount. The Reserve Bank of India would, in future, have the power, under directions from the Government, not only to buy and sell Sterling *but other currencies also.* In practice, however, the Reserve Bank of India would continue as before to deal in Sterling only till India's Sterling Balances had been settled and as a consequence her foreign exchange position had been cleared.

It is important to restate that at the time of arriving at the final decision to join the International Monetary Fund, the Interim Government had taken the decision *not to make any* change in the Rupee-Sterling exchange rate. That decision has been adhered to. But the fixing of the rate of exchange in the future has been left, by the new amendment, to be determined

by the Central Government instead of by the Reserve Bank of India as hithertofore. Besides, as the Rupee would in future be exchangeable with a multitude of foreign currencies, it was not appropriate under the present conditions to lay down all the exchange rates. However, it is all for the good that statutory provision is made, so that changes in exchange rates could be made as quickly as possible and with the greatest secrecy, so necessary to withstand the onslaught of speculators.

It may also be recalled that although Sections 40 and 41 of the Reserve Bank of India Act were originally designed to maintain the external value of the Rupee, they were made use of during World War II to supply Rupee-finance to His Majesty's Government and other Allied Governments for financing war supplies, in exchange for Sterling created in favour of India. These resulted in the Sterling Balances and the consequent inflation in India. The removal of these Sections has drawn the curtain down on the painful episode, which has no chance to make its reappearance under the protection of a statute.

BOOK II

Development of the Indian Currency System during the Nineteenth and the Twentieth Centuries upto the outbreak of World War II

CHAPTER XIV

Currency History before 1835

(Two standard coins of different metals)

CURRENCY BEFORE 1800 :—At the beginning of the 19th century no uniform standard coin existed in British India. In Northern India, *a silver standard* existed with gold coins in concurrent circulation, but there was *never any fixed legal ratio between them.* The Muhammadan rulers on the whole preferred silver coinage. In *Southern India*, on the contrary, where the Muhammadan conquests never extended, the *Hindu* rulers adopted *gold* as the standard.

Thus, throughout India *two standard coins* of both gold and silver were in circulation side by side *without any fixed relation* between them. The exchange value of the coins was determined by their weight and fineness.

The East India Company "found 994 different kinds of gold and silver coins current of *different weights and fineness*, and whose value was constantly varying from day to day. No one could tell the value of the coins he might hold. In making even moderate payments the parties were obliged to call in a shroff—a professional money changer—to declare the value of each coin."*

EARLY EFFORTS OF THE EAST INDIA COMPANY :—Finding this extremely embarrassing for revenue collection and business transactions, the East India Company attempted to issue both gold and silver coins *at a fixed legal ratio.* This establishment of Bimetallism, however, ended in a failure as the legal ratio could not possibly be maintained while the market value of the metals was constantly fluctuating.

But with the appearance in 1806 of Lord Liverpool's treatise on the *Coins of the Realm*, the importance of the principle of Monometallism was made clear and the Governor-General in Council declared his entire adherence to it. But the choice of the Government fell on *silver* as the standard.

DESPATCH OF 1806 :—The Court of Directors of the East

* H. D. Macleod ; *Indian Currency*, page 13.

India Company addressed a despatch on the 25th April 1806, to the Governments of Bengal and Madras in which they expressed themselves fully in favour of monometallism, and as regards the establishment of a standard they wrote that "they were fully satisfied with the propriety of the *silver rupee being the principal measure of value* and the money of account." But they did not desire to drive gold out of circulation, and they even proposed that a gold-rupee of the same weight and fineness as the silver coin should be coined without a ratio being fixed between the two coins.

SILVER COIN IN MADRAS PRESIDENCY, 1818 :—No action was taken on this minute until 1818, when the Government issued a new coinage of silver and gold. *They substituted the silver rupee for the gold pagoda as the standard coin of the Madras Presidency*, where gold coins had been the standard currency for thousands of years. The rupee weighed 1 tola or 180 grains. But they declared these gold and silver coins to be equally legal tender. Thus in spite of the minute of 1806 "they persevered in the *vain attempt to maintain Bimetallism*."*

However, the various Presidencies under the East India Company had rupees of different weights and fineness and the rupee of one Presidency was not legal tender in another. Great inconvenience, therefore, arose in making payments, and in actual payment they were weighed as bullion. A uniform system of coinage was, therefore, found necessary.

ACT OF 1835 ; THE SILVER STANDARD RUPEE MADE LEGAL TENDER :—Such a uniformity was obtained by the Act of 1835.

The essentials of the Act were as follows :—

(1) The Silver Rupee of the weight of 180 grains troy (150 grains pure metal and 15 of alloy or 11/12th fine) was declared to be the *standard coin and legal tender in India* and the silver coins were to be of proportionate weight.

(2) It also enacted that "*no gold coin* shall henceforward be *a legal tender* of payment in any of the territories of the East India Company."

(3) But it also authorized the coining of gold mohurs (15-rupee pieces) which were of the same weight and fineness

* H. D. Macleod: *Indian Currency*.

as the rupee, and 5, 10 and 30 rupee pieces of the same standard as the gold mohur.

CONCLUSION :—*Thus silver monometallism was established in India*, and although gold had ceased to be legal tender in India as between private individuals, the provision made for coining the gold mohur meant that the authorities did not entirely discourage the use of gold by the people.

CHAPTER XV

Consequences of a Fall in the Price of Silver
1835-1893

- **Part I, 1835-1874**
  (Demonetization of gold)
  - **(A) 1835-1870**
    - (i) Demonetization of gold
    - (ii) Attempts at introduction of gold
  - **(B) 1870-1874**
    (Gold not legal tender)
- **Part II, 1874-1893**
  (Falling and unstable exchange)
  - **(A) 1874-1878**
    (Rapid fall in price of silver)
  - **(B) 1878-1892**
    The remedies ?
  - **(C) 1892-1893**
    - (i) Herschell Committee's report
    - (ii) Closing the mints to free coinage of silver

IMPORTANCE OF THE PERIOD 1835-1893 :—This period of the history of Indian Currency is very instructive from the economic point of view. For, in the first place, a change in the value of precious metals, silver and gold, brought with it great difficulties in maintaining the stability of the rupee ; and secondly, to come out of these difficulties successfully various experiments were suggested and tried (one of which was already the favourite of a certain part of Europe then). We have, therefore, to trace the causes of the difficulties, and to see whether they were remedial or not, and then try to measure the value of the experiments made. Both these difficulties and the efforts made to overcome them, are important for study in the light of future history.

PART I—The Period 1835-1874

(Demonetization of gold)

(A) Events between 1835-1870

(i) Demonetization of gold.

(ii) Attempts at introduction of gold.

PROCLAMATION OF 1841. EXTENSION OF THE USE OF GOLD :—We saw in the preceding chapter that the Act of 1835 made the silver-rupee the Standard coin for India. But the people continued to demand the use of gold coins and a proclamation had, therefore, to be issued on the 13th January 1841, which authorized officers in charge of public treasuries " freely to receive gold mohurs at the rates, until further orders, respectively denoted by the denomination of the pieces." As the gold mohur and the silver rupee were of identical weight and fineness, this proclamation represented a ratio of 15 : 1 between gold and silver. In this way the use of gold as currency was extended.

(i) LORD DALHOUSIE DEMONETIZED GOLD CURRENCY, 1853 :—But the extensive discoveries of gold in Australia in 1848 and 1849 caused the value of gold to fall relatively to silver. It was, therefore, held by the Directors of the Company, on representations from the Government of India, that the proclamation of 1841 had embarrassed the Government and was likely to do so still more. The reason given was that " holders of gold coin have naturally availed themselves of the

opportunity of obtaining from the Government treasuries a larger price in silver than they could obtain in the market."* People were eagerly paying for their debt to the Government in gold, the depreciated metal, and what they gained the Government lost. Consequently a notification was issued on 25th December 1852, by which the above provision of 1841 was withdrawn and it was declared that, on or after 1st January 1853, "*no gold coin will be received* on account of payments due, or in any way to be made, to the Government in any public treasury within the territories of the East India Company."

By this notification gold was completely demonetized in India, and it was estimated that "£120,000,000 worth of gold coin at once disappeared from circulation and became hoarded wealth."†

FALL IN THE PRICE OF PRECIOUS METALS :—We have just referred to the fall in the value of gold. We shall now try to know its extent and its consequences. For many centuries the market ratio of exchange between gold and silver was 15 tolas of silver : 1 tola of gold. Any change therefore in the relative values of these metals was bound to bring about a change in the mint ratio of these metals. And this was what actually happened during that period, although not so acutely as in the succeeding one. New rich gold fields were discovered in California and Australia and in 1851 the world's production of gold began to increase. This led to a fall in the price of gold, and silver became relatively the dearer metal.

If, however, the fall in the value of gold had been heavy, relatively to silver, the intrinsic value of the Rupee would have risen appreciably and therefore its exchange value would have been raised accordingly. But fortunately this occasion did not arise because, (1) the stock of silver in the world's market began to increase as a consequence of the play of Gresham's Law in France. This country was then bimetallic and the cheaper gold coins drove out the dearer silver coins from currency. (2) Secondly, from 1865 the production of silver in the world also began to increase.

Thus, the ***increase in the supply of silver tended to compensate for the increase in the supply of gold*** and the latter did not depreciate much and the change in the ratio was slight.

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* Quoted from Fowler Committee Report, para 5.

† H. D. Macleod: *Indian Currency*.

(ii) ATTEMPT TO INTRODUCE GOLD CURRENCY INTO INDIA :—During the whole of this period we find a keen agitation by the people for the introduction of a gold currency. Efforts on the part of the Government of India were made to extend the use of gold coins. Every Finance Member favoured the introduction of a gold currency. In 1864 the Chambers of Commerce of the three Presidencies memorialized the Government of India for a gold currency.

(I) SCHEME OF 1864 :—Sir Charles Trevelyan, the Finance Member, drew up an exhaustive scheme in favour of it in 1864, but it was not accepted by the then Secretary of State, Sir Charles Wood. It was, however, thought that an experiment might be tried to see if the people of India would be willing to use gold coins and it was declared by the Government of India in November 1864, that

(*a*) Sovereigns and half-sovereigns minted at any authorized Royal mint in England or Australia should be accepted by the Government of India in payment by its debtors, as the equivalent of Rs. 10 and Rs. 5 respectively.

(*b*) the Government of India should, when convenient, pay the same to its creditors if they desired to receive them in payment. Even notes were also authorized to be issued under limitations in exchange for such gold coins.

(II) SCHEME OF THE MANSFIELD COMMISSION :—But such a half-hearted attempt to introduce the gold currency was not likely to encourage its use into general circulation. The agitation, however, went on and in 1866 a commission* was appointed to report on the best expedient to satisfy the currency demands of the increasing commerce and prosperity of the country. The recommendations of the Commission were as follows :—

(1) that gold coins† of 15, 10 and 5 rupees respectively would find more favour in the eyes of the people than notes of like value ;

(2) that the introduction of gold would facilitate the establishment of the currency notes ; and

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* The President of this Commission was Sir William Mansfield.

† The Commission modified the units because they proved that the rupee price of the sovereign was not correctly determined by the proposal of 1864. The real par of the sovereign was somewhat above Rs. 10.

(3) that the opinion was almost unanimous that the currency should consist of gold, silver and paper.

In the end they expressed a hope that, with such evidence of the general wish of the country before them, the Government of India would persevere in recommending to the Secretary of State the making of gold coin legal tender in India.

THE ATTEMPTS END IN FAILURE :—Nothing substantial resulted, however, from these recommendations and the experiment of the limited introduction of gold into circulation was carried on. In 1868 the rate for receipt of sovereigns and half-sovereigns was raised from Rs. 10 and Rs. 5 to Rs. 10-8 and Rs. 5-4 respectively (as the rate was sometimes below the average market value of the sovereign).

ACT OF 1870 :—In 1870 the Indian Coinage Act was passed which consolidated and amended all previous legislation.

(B) 1870-1874 : (Gold not legal tender)

BEGINNINGS OF A FALL IN THE VALUE OF SILVER :—Nothing eventful occurred during the first two years of this period, but the coming in of the year 1872 brought with it a distinct change in the relative values of gold and silver. What were the causes that brought about this change ?

In 1871 Germany had decided to adopt the gold standard and abandon the silver standard. She now began to import large quantities of gold and as a consequence threw out silver coin from the country. Her example was followed by Denmark, Sweden, Norway and Holland. Consequently the stock of silver coins in the market increased considerably.

But this was not all. Other countries, *viz.*, France, Belgium, Italy and Switzerland, that had joined together into a *Bimetallic Union*, known as the Latin Monetary Union, began to find it difficult to keep up the fixed Bimetallic Standard, because silver began to take the place of gold in these countries. They, therefore, suspended the free coinage of silver in 1874 (and silver coin in fact became a token coin).

These two events brought with them the beginning of a fall in the price of silver.

GOLD NOT LEGAL STANDARD :—When these great changes were taking place in Europe, yet another attempt was

made to obtain for India a gold currency. In 1872, Sir Richard Temple, the Finance Member, put before the Government of India a scheme for making gold coin legal tender in India. Writing in his able minute very strongly in favour of gold currency, he observed : "On the whole it seems clear that while, in all other branches and departments of administration, we endeavour to give to India the best of everything so far as we can, yet, in respect to metallic currency, we deliberately withhold from her the first-rate article and afford her a second-rate one."

But India was not destined to have this privilege. Sir Richard Temple resigned in April 1874, and it was found that in the following month the Government of India decided against the recognition of gold as a legal standard of value in India. No reason whatsoever was stated for adopting a resolution which categorically ran thus : "The expediency of introducing a gold currency having been considered, the Governor-General in Council is not at present prepared to take any step for the recognition of gold as a legal standard of value in India."

PART II—The Period 1874-1893

(Falling and unstable exchange)

Section A. 1874-1878

RAPID FALL IN THE PRICE OF SILVER—ITS CAUSES : We have just stated above the causes which brought the beginnings of a fall in the price of silver. But this fall became very rapid from 1874 and did not stop for nearly 20 years. There were many causes which combined to bring about this rapid fall. For the sake of convenience we shall divide them into two parts.

(i) *Those on the side of silver.*
(ii) *Those on the side of gold.*

(i) FACTORS AFFECTING SILVER :—Looking to the ***demand*** side for silver we find that, if there was no great reduction in its use by Europe and America during these years, at least the fact remained that these countries did not want more silver than before. It may be granted then that the demand

remained nearly the same as before.

But the supply of silver increased considerably and the factors which led to this were the following :—

(*a*) As stated above most European countries adopted the gold standard and as a consequence large quantities of silver coins went to the market.

(*b*) *New* silver was being steadily produced in larger and larger quantities. Not only were new mines discovered but new inventions simplified the process of producing silver.*

In 1891 the production of silver from the mines was more than double what it was in 1876.

(ii) FACTORS AFFECTING GOLD :—At the same time gold was appreciating in value.

(*a*) In the first place there was an increased demand for gold currency in Europe and America to meet the requirements of the increase in trade.

(*b*) In the second place the production of gold in the world declined.

CONCLUSIONS :—These, therefore, combined to bring about a fall in the general level of gold prices. And as a consequence, ***the price of silver as a commodity also fell in terms of gold.***

ITS CONSEQUENCES FOR INDIA :—This rapid fall in the price of silver also affected India.

(1) The first natural consequence was ***a fall in the rate of exchange***. The Table below shows clearly how closely related are the price of silver and the rate of exchange.

YEAR	PRICE OF SILVER	RATE OF EXCHANGE	
	d.	*s.*	*d.*
1871–72	$60\frac{1}{2}$	1	$11\frac{1}{8}$
1875–76	$56\frac{3}{4}$	1	$9\frac{5}{8}$
1879–80	$51\frac{1}{4}$	1	8
1883–84	$50\frac{1}{8}$	1	$7\frac{1}{2}$
1887–88	$44\frac{5}{8}$	1	$4\frac{7}{8}$
1890–91	$47\frac{11}{16}$	1	$6\frac{1}{8}$
1891–92	45	1	$4\frac{3}{4}$
1892–93	***39***	***1***	***3***

* H. Stanley Jevons: *Money, Banking and Exchange in India.*

(2) The cheap silver was imported into India in large quantities to liquidate her favourable balance of trade. It may be recalled that silver standard coin was unlimited legal tender in India at this time. And when this silver entered into circulation as money, the total currency in circulation exceeded what was actually needed and it resulted in a *rise in the general level of prices.*

YEAR	PRICES
1873	100
1883	99
1893	129

The above Table shows that prices in 1893 reached 129 as against 100 in 1873.

(3) The depreciation of the rupee brought the Government of India in great financial difficulties. The Government had yearly to remit a very large sum to England in discharge of their gold obligations known as the "Home Charges." At a rate of exchange of, say, 2*s*., to remit every £1 to England would mean paying Rs. 10, *plus* the cost of sending it ; but, at 1*s*. 3*d*. to remit £1 would mean paying nearly Rs. 16 *plus* the cost of sending it. The great loss arising from this operation *converted a surplus Budget into a deficit Budget.* The total loss estimated was great as compared with the revenues of these years. We shall consider it when we analyse the report of the Herschell Committee (in Section C).

Section B. The Remedies suggested during 1878-1892

The continuous fall in the gold price of silver and in the rate of exchange resulted in great uncertainties in commerce and trade. If the future of prices and the rate of exchange could not be foreseen with certainty by businessmen, it would be very difficult for them to know their profits and therefore contracts would be curtailed. We therefore find that during these four years agitation was started by men and institutions connected with commerce in favour of the closing of the Indian Mints to the free coinage of silver and for the adoption of a gold standard.

(*a*) SCHEME OF THE GOVERNMENT OF INDIA :—In the year 1878, aiming at the ultimate adoption of the British standard, and the extension to India of the use of British gold coins, the Government of India represented that

(i) they should be given the power to receive British and British Indian gold coin in payment for any demands of the Government at rates to be fixed from time to time until the exchange had settled itself sufficiently to enable them to fix it permanently at 2*s*. ;

(ii) simultaneously with this, the seigniorage on the coinage of silver would be raised to such a rate as would virtually make the cost of a rupee, to persons importing bullion, equal in amount to the value given to the rupee in comparison with the gold coins spoken of above.

The result of these suggestions would be that a " self-acting system would be obtained under which silver would be admitted for coinage at a fixed gold rate as the wants of the country required ; while a certain limited scope would be given for the introduction and use of gold coin, so far as it was found convenient or profitable."*

THE FATE OF THE PROPOSALS :—These proposals were referred by the Secretary of State to a Committee who unanimously reported *against* them. Their verdit was accepted by the Secretary of State, who in writing to the Government of India stated, " Of one thing my Lords are sure, that it is better to sit still, than to have recourse, under the influence of panic, to crude legislation the result of which cannot be foretold, and the effect of which cannot be measured."

(*b*) ATTEMPTS AT INTERNATIONAL BIMETALLISM :—When such attempts failed, the Government of India tried to seek relief in an *international agreement*, which might cause a rise in the gold price of silver and thus diminish the disastrous consequences resulting from the continuance of the silver standard.

It is important to note at this stage that between 1867-1892, *four great International Monetary Conferences* were held to solve the currency difficulties of various countries of Europe and America.

* Government of India's Despatch to the Secretary of State, July 1878.

THE FIRST CONFERENCE :—The *first* Conference was held at Paris in 1867, which was attended by the representatives of 18 principal countries of Europe and the United States of America. Every country at this time was aiming at securing gold for its currency in sufficient quantity and at the cheapest price possible. "It was a scramble for gold." It was not, therefore, strange that at this Conference it was resolved that "the relation between the value of gold and silver should not be established at a rate too low to permit the serious introduction of gold", particularly in countries having the silver standard. At the same time gold was declared to be the only standard suited to international money.

The decision of this Conference gave a clear hint that it would not be possible to have a gold currency easily established in India.

THE SECOND CONFERENCE, AUGUST 1878 :—A few months before the *second* Conference met in August 1878, the United States of America made a strenuous effort in the direction of Bimetallism in the country by passing what is known as the *Bland Allison Act.* By this Act silver which was dethroned as money in 1873, was to be restored as a legal tender money, and to do this the Secretary of the Treasury was required to purchase and coin each month not less than 2 million dollars and not more than 4 million worth of silver into *standard* silver dollars. The purchases were made but they were not sufficient to raise the price of silver, which continued to fall.

Consequently, the United States of America took the lead in convening this Conference and in proposing the adoption of a common ratio between gold and silver for the purpose of establishing internationally the use of bimetallic money, and securing fixity of relative value between those two metals.

But the proposals were *not* accepted by the Conference because *the interest of the gold-using countries would not allow gold to be introduced as currency by silver-using countries.* To the increasing demand for gold would be added the new demand from silver-using countries ; the price of gold would, therefore, soar high, and would embarrass the gold-using countries.

The faith of the Government of India in Bimetallism was however not lost and in December 1897, they expressed the opinion

(*a*) that the bimetallic standard was the best system of currency;

(*c*) that it could be obtained by an international agreement between France, Germany, United States and India: and

(*c*) that the ratio between gold and silver should be 1 : 15½.

Thus India was to obtain "unquestionable and quite incalculable financial benefit."*

THE THIRD CONFERENCE, JULY 1881 :—The *third* Conference met in July 1881, and this time at the instance of France and the United States of America. The proposals were the same as before, of introducing International Bimetallism. Nineteen countries joined the Conference but England sent her delegates on the clear understanding that she was opposed to Bimetallism, and that they were sent there not to vote but to give every information the Conference required. Two such delegates represented the Government of India, "but it was understood that the Government of India were not committed to the principle of bimetallic system in India."

The proposals of the French and American Governments for a double standard of value did not meet with the approval of the Conference, and it failed in its object of establishing International Bimetallism.

(*c*) THE GOLD AND SILVER COMMISSION :—In 1886 a Royal Commission known as the Gold and Silver Commission was appointed in England to enquire into the recent changes in the relative values of the precious metals, owing to the decrease in the gold price of silver. The Commission gave its report in 1888. Half the members wrote against Bimetallism on the ground that the change proposed was tremendous and that the public mind was not prepared for it. Of the other half, who wrote in favour of Bimetallism, was Sir David Barbour who represented India. But owing to this divided verdict no action was taken on the report.

THE SHERMAN ACT :—In 1890 the United States seemed to come to the help of the silver-using countries indirectly. They passed the Sherman Act which required the Government to buy annually no less than 54 million ounces of silver. The purchases amounted to 35 to 43 per cent. of the world's produc-

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* Government of India's Despatch to the Secretary of State, December 1897.

tion. This quantity represented nearly three times that brought under the Bland Allison Act of 1878. This artificial demand for silver undoubtedly tended to raise the price of silver and brought with it rash speculation on the part of traders and "trade between India and England became nothing short of a gamble in exchange", with all its attendant evils. But the rise in price of silver turned out to be of temporary duration, and on the contrary the *price began to fall very rapidly*, and was expected to fall to a lower level in the future.

YET ANOTHER EFFORT :—The Government of India, therefore, made yet another effort in 1892 to induce the British Government to settle the silver question by an international agreement. They made out a strong case for such a step being taken, because should an international agreement fail, the United States of America might be forced to repeal the Sherman Act and the consequences of their action would be disastrous on the price of silver.

THE FOURTH CONFERENCE, JUNE 1892 :—In June 1892, the President of the United States of America invited other countries to a Conference at Brussels to settle the silver question, at this time not by the weapon of Bimetallism but to settle "what measures, if any, can be taken to *increase the use of silver* in the currency system of nations". Although the purpose for which the conference was called was different from that of the preceding ones, it failed to find any definite and practical scheme upon which a large number of the delegates could agree. At the same time the representatives of the United States declared that their Government might be disinclined to continue their purchases of silver, *i.e.*, the Sherman Act might be repealed, and that they were determined to protect their stock of gold.

DESPATCH OF THE GOVERNMENT OF INDIA OF JUNE 1892 :—The same month in which the Brussels Conference met, the Government of India wrote a despatch in which they emphasized that, if the Brussels Conference would fail, two steps should be taken :

(1) that the Indian mints should be closed to the free coinage of silver ;

(2) and that arrangements should be made for the introduction of *a gold standard*.

The proposal was placed before a Committee known as the

Herschell Committee which was sent out to India for their examination.

Section C. 1892-1893

The Herschell Committee's Report

THE QUESTION BEFORE THE COMMITTEE :—The question referred to the Herschell Committee was whether, taking into account the grave difficulties with which the Government of India were confronted through the heavy fall in gold value of silver, it would be expedient to allow the Government to carry into effect the proposals which they had made for stopping the free coinage of silver, with a view to introducing a gold standard.

(i) FINANCIAL DIFFICULTIES OF THE GOVERNMENT OF INDIA :—(A) The key to the whole situation was to be found in the fact that the Government of India had to make remittances annually from India to England to the extent of nearly £17 millions sterling and the fall in the value of silver, and with it the rupee, meant that more and more rupees were required to remit every £ than previously. The following table shows clearly the extent of the loss incurred.

YEAR	Amount remitted in £	At rate of exchange	Rupee cost of remittance
		s. *d.*	Rs.
1892–93	16,532,215	1 2.985	26,47,84,150
1873–74	to remit the same amount	1 10.351	14,26,57,000

(B) And this additional sacrifice had converted a surplus budget into a deficit budget in spite of improvement in revenue, and as the whole revenue of India in 1892-93 was only Rs. 90 crores, the loss of that sum was really very serious in those days.

(C) Nor was this all. A further fall in the price of silver was contemplated. "A repeal of the Sherman Act might lead to a fall in the price of silver of even 6*d.* per ounce, or more,

and that there might be no substantial reduction from the level thus reached. Such a fall would, it may be said with practical certainty, reduce the exchange to about 1*s*. 0*d*., per rupee, and involve the necessity of raising at least Rs. 6,612,000 more than would be required by the Government of India to effect, even at the rate of exchange of 1*s*. 3*d*. per rupee, a remittance of the amount drawn last year (1892-93).''*

(D) The means available for making up the deficit were either increase of taxation or curtailment of public expenditure.

(1) First, as to the possibility of increasing taxation. After reviewing the means of taxation which had been in use then, the Committee considered the new sources of taxation which were suggested to them, but they came to the conclusion that the additional revenue could be obtained " only in a manner opposed to sound principles of taxation."

(2) As regards the possibility of reducing expenditure, they stated that " no economies were possible which would enable the Indian Government to meet successfully the great and growing deficit caused by falling exchange."

(ii) EFFECT OF FALL IN EXCHANGE ON THE PEOPLE OF INDIA AND ITS COMMERCE :—The Committee tried to prove that the burden upon the people of India as a whole had *not been increased* by the fall in exchange. The arguments in support of their statement were given as follows :—

(*a*) EFFECT ON REMITTANCE OF PRODUCE :—A fall in exchange must make necessary the raising of increased number of Rupees to meet the Sterling remittances of the Government of India. But they stated that the burden so imposed was to be measured by " the quantity of produce which they represent, for it is by the export of produce that the debt is in reality discharged. . . . The question to be considered was what effect had the fall in exchange upon the amount of produce which must be exported to meet a given gold liability ? To determine this, the gold price of the produce must be assumed to be stationary. When silver falls in relation to gold, the greater number of rupees which is required to meet a given gold payment will *not* represent a greater quantity of produce than before, *if the silver price in India of the produce exported responds to the changed*

* Herschell Committee Report.

value of silver in relation to gold, *i.e.*, if *it has risen* or has been prevented from falling. Silver prices must ultimately thus respond, although an interval may elapse before the correspondence is complete ; and during this time, whilst more produce is exported, the Indian ryot is getting proportionately *less* in silver for his produce."

(*b*) TRANSFER OF BURDENS FROM ONE CLASS TO ANOTHER :—There was no doubt that the burden had been to some extent shifted from one class to another. (1) The burden of those who pay a fixed land revenue under a permanent settlement had been lightened. (2) But the increased salt tax would press upon the people at large, and would render the taxation heavier on those who have suffered rather than benefited from the higher rupee price due to the fall in the gold value of silver.

(*c*) HARASSMENT OF TRADE BY FLUCTUATIONS :—It was indeed commonly agreed that trade was seriously harassed by fluctuations. Any sudden or violent fluctuation almost paralysed business for a time. It was however observed by the Committee that it was not so much the fall of exchange which was complained of, as the fluctuations, whether in one direction or another.

(*d*) ALLEGED STIMULATION OF EXPORTS :—It was said that the tendency of a falling exchange was to stimulate exports ; that, inasmuch as more silver, *i.e.*, a higher silver price was received in respect of the same gold price, whilst wages and other factors in the cost of production did not increase in the same proportion, production became very profitable, and was, therefore, stimulated.

" Assuming this to be true," said the Committee, " the effect of each successive fall must be transitory, as can continue only until circumstances have brought about the necessary adjustment." Even assuming the proposition that a falling exchange stimulated export was true, the examination of the statistics of exported produce did not afford any substantial support to it. On the contrary, statistics proved that export trade had been less with a rapidly falling than with a steady exchange. For example, from 1871-72 to 1876-77, the gold value of the rupee fell 11¼ per cent., but exports were actually less in the latter year

than in the former, and imports increased by 17 per cent.

(*e*) CHECK TO INVESTMENTS IN INDIA :—It was alleged that "the want of a stable exchange between England and India, and the fact that it has fallen so heavily, has greatly checked the investment of British Capital in India and the consequent development of the country."

But the Committee stated that this check was due to other causes which were more substantial. "Capitalists have been slow to invest in many kinds of industrial enterprise, owing to the fact that prices are falling, or have fallen, very generally. Besides, London is the lending market and London thinks in gold. London is ready enough to lend upon contracts for repayment in gold, but hesitates to enter upon silver transactions, or to engage in industrial enterprises in a silver country."

(*f*) INDIA MADE TO BUY DEPRECIATING SILVER :—It was said that, by making silver the standard, and keeping the Indian mints open to silver, "the Anglo-Indian Government have attracted to India that depreciating metal, and have thus made India purchase, at a comparatively higher cost, an enormous quantity of it, which is now of less value than when it was brought."

To this the Committee answered, "In this there is some truth, but also much exaggeration. . . . What this loss amounts to cannot be determined, but we are not without indications that India is becoming *surfeited with silver.*"

(iii) PROPOSALS OF THE GOVERNMENT OF INDIA CONSIDERED : DESPATCH OF 21ST JUNE 1892 :—In a despatch of 21st June 1892, the Government of India expressed their deliberate opinion that, if it became clear that the Brussels Conference was unlikely to arrive at a satisfactory conclusion, and if a direct agreement between India and the United States were found to be unattainable, they would at once close the mints to the free coinage of silver and make arrangements for the introduction of *a gold standard* into India.

SIR DAVID BARBOUR'S PLAN FOR A GOLD STANDARD :—Together with these proposals was also despatched a minute by Sir David Barbour, the Finance Member of Council, giving an outline of the method he proposed for the introduction of a gold standard into India. The nature of the plan was

as follows :—

(1) The first measure would be the stoppage of the free coinage of silver. Government would retain the right of purchasing silver and coining it into rupees.

(2) The next measure would be to open the mints to the free coinage of gold. A man bringing gold to the mints would be entitled to have it coined into gold coins, which would be legal tender to any amount. It would be desirable to stop the free coinage of silver before opening the mints to the free coinage of gold.

(3) The new gold coins to be a 10-rupee piece and a 20-rupee piece.

(4) The weight and fineness of gold coins would be such that the par of exchange between them and the sovereign would be the exchange which it was desired to establish between England and India.

For example, if the Rupee was to be worth 1*s*. 4*d*., the 10-rupee coin would contain as much gold as was worth (1*s*. 4*d*.) x 10 = 160 pence. The quantity of fine gold in the 10-rupee piece would be 160/240ths or two-thirds of the quantity contained in the sovereign.

(5) The proposals as to the fixation of the ratio of exchange from the silver to the gold standard were as follows :—

(*a*) "We ought not to think of going back to the old ratio of 1 : 15½. Neither ought we to adopt the very lowest price to which silver may have fallen at any time."

(*b*) "A ratio based on the average price of silver during a limited period before the introduction of the gold standard would probably be both the safest and most equitable."

HIS ARGUMENTS :—In support of his scheme, he observed : (1) Although it was proposed to stop the free coinage of silver and to establish a gold standard, *it was no part of the plan to substitute gold for silver as the ordinary currency of the country*. It was contemplated that, in the vast majority of Indian transactions, *silver would still be used* as a medium of exchange. He referred to the example of France and other nations as showing that it was possible to have a gold standard, though a large percentage of the circulation consisted of overvalued silver coins, which were legal tender to any amount. (2) In order that the gold standard might be effective, *a limit must be placed* on

the number of such coins, and they must be convertible into gold coins with or without the paying of a trifling premium. Gold coins would only be required in exchange for silver when they were wanted for hoarding or export or for melting down into ornaments.

TELEGRAM OF 22ND JANUARY 1893 :—In a telegram of the 22nd January 1893, the Government made the following further statement regarding their proposals :—

(1) that English Gold coinage shall be legal tender in India, at a rate of not less than 13-1/3 *rupees for one sovereign,* i.e., *the rate of* 1s. 6*d*. *per rupee* ;

(2) that power to admit sovereigns as legal tender might be of use as *ad-interim* measure and *will not* be used except in case of necessity.

THE COMMITTEE'S CONSIDERATION OF THESE PROPOSALS :—But the Committee decided (1) *against* the suggestion for introducing gold currency and (2) *against* the fixation of a higher ratio, *i.e.,* 1*s*. 6*d*. per rupee as recommended by the Government of India.

(A) THAT GOLD CURRENCY WAS UNNECESSARY AND UNDESIRABLE :—As regards the introduction of gold currency, they wrote that it was both *unnecessary* and *inadvisable.* In support of their statement they gave a survey of the different currency systems of various countries.

(1) METHODS ADOPTED BY OTHER COUNTRIES :—The lesson drawn from a study of these systems was that many countries had adopted the gold standard, and a substantial parity of exchange with gold-using countries was maintained by them *without actually using gold or using very little of it in circulation.* The methods adopted to maintain the parity of exchange were under the following conditions :—

(*a*) With little or no gold, as in Scandinavia, Holland and Canada.

(*b*) Without a mint, or gold coinage, as in Canada and the Dutch East Indies.

(*c*) With a circulation consisting partly of gold, partly of overvalued and inconvertible silver, which was legal tender to an unlimited amount, as in France and other countries of the Latin Union, in the United States, and also in Germany, though there, the proportion of over-

valued silver was more limited, the mints in all these countries being fully open to gold, but not to silver, and in some of them the silver coinage having ceased.

(*d*) With a system under which the banks part with gold freely for export, as in Holland, or refuse it for export, as in France.

(*e*) With mints closed against private coinage of both silver and gold, and with a currency of inconvertible paper, as had been temporarily the case in Austria.

(*f*) With a circulation based on gold, but consisting of token silver, which, however, was legal tender to an unlimited extent, as in the West Indies.

THE LESSON FOR INDIA :—The general conclusion drawn by the Committee was " that it had been found possible to introduce a gold standard *without a gold circulation* ; without a large stock of gold currency ; and even without legal convertibility of an existing silver currency into gold."

It was admitted by the Committee that what was true of other countries could not necessarily be true of India. Even in the case of Holland and its East Indian Colonies, which was *prima facie* very much in point, " there are differences which detract from its value as a precedent for India." Yet, they stated, " the experience derived from the currencies of other countries is not without value as bearing on the questions we have to consider."

They failed to emphasize the fact that in every one of these cases the same general principle was exemplified, the principle of *limitation*, first definitely established by Ricardo.—"Any kind of currency can be maintained at an artificial value, provided only that it is strictly limited."

(2) ITS PROBABLE EFFECT ON SILVER COINED AND UNCOINED :—They also found the introduction of gold currency *inadvisable* because it would have an adverse effect on the gold value of (*a*) uncoined silver and of (*b*) coined rupees.

(*a*) ITS EFFECT ON THE GOLD VALUE OF UNCOINED SILVER : INDIA'S DEMAND FOR SILVER :—Judging from the following figures it would be seen that India absorbed nearly the whole of silver imported into it.

1875-76 to 1892-93: Yearly Average

Total demand of India for currency	Net imports of silver
Rs. 77,00,000 (and more) ...	Rs. 83,28,344

Besides, the currency demands of India had during those years been nearly $\frac{1}{4}$, and those of the United States more than $\frac{1}{3}$ of the whole world's production.

If, therefore, either the one or the other were to cease, there ought, according to general laws, to be a great fall in the value of silver, and if both were to cease the fall would be precipitous.

(1) POSSIBLE PANIC IN SILVER MARKET :—The closing of the Indian mints would, no doubt, make it more likely that the United States would give up buying silver, and, if the apprehension of this were added to the cessation of the Indian demand, the effect might be a panic in the silver market. Ultimately, however, the price of silver would settle down to the new circumstances of demand and supply.

(2) POSSIBLE RISE IN VALUE OF GOLD :—If the effect of the proposal of the Indian Government were, sooner or later, to cause a demand for gold in India, which did not exist then, it might raise the value of gold as against all other things, including silver, *i.e.*, the gold price of silver might be still further diminished.

(*b*) ITS EFFECT ON THE VALUE OF COINED SILVER : Next, as to the effect of simply closing the mints, on the future value of gold price of the rupee. If there were already, as there was reason to suppose, a quantity of unused rupees in India, they would have to be absorbed before the closing of the mints produced an effect on the value of the rupee. In that case, there might be some time to wait before there was any increase in its value.

(B) THAT 1*s*. 6*d*. RATIO WOULD BE INJURIOUS TO INDIA :—Consideration was next given to the effects of raising the ratio to 1*s*. 6*d*. as proposed by the Government. In order to make these effects clear they considered the probable results

of closing the mints to the free coinage of silver *without* the ratio being raised to 1*s*. 6*d*.

(*a*) *Supposing the ratio were not to be raised, and silver were to fall owing to the closure of the mints :*

(1) It was represented by some that a serious amount of spurious coinage would result. But the Committee expressed their opinion that it was difficult to estimate precisely the real extent of the alleged danger, and that, as expensive and specially constructed machinery would be requisite to carry out such operations on an extended scale, they doubted whether the danger of India being flooded with large amount of spurious coins would really be a grave one.

(2) Next, the effect of closing the mints (on the assumption taken above) on the *hoards of silver* coined and uncoined in India itself was considered.

Coined rupees, of which the hoards chiefly consisted, would, they wrote, be unaffected, except in so far as any further fall in their gold value would be prevented ; but *the uncoined silver and silver ornaments* would cease to be convertible into rupees, and would certainly be *depreciated in value*.

(3) Another objection raised was that the proposal would, if there should, in future, be a divergence between the value of the rupee and the market price of silver, have the effect of converting the whole of the currency of India into a *token currency* which would not differ in principle from an inconvertible paper currency.

But the Committee stated that one of the greatest risks connected with an inconvertible paper currency, *i.e.*, the temptation which it afforded to the Government of expanding unduly the amount in circulation, did not exist in the proposals of the Indian Government.

(4) It was also objected that placing power in the hands of the Government of expanding or contracting the currency at will, would *not make* the currency *automatic*.

But the Committee stated the assumption was that the exchange *was not to be practically raised above the level which then existed*. If the rupee were to rise above the fixed ratio to such an extent as to cover the expenses of transmission and of coinage, it would become profitable to take gold to the Indian

mint, or to send sovereigns to India, and thus the currency *would be made automatic on a gold basis.*

(5) Another serious objection urged was that, if the proposal of the Government were carried out, and there should arise a great *divergence* between the ratio borne to gold by the rupee and by silver respectively, it would *seriously affect the trade of India with silver-using countries,* and stimulate in those countries the production of commodities which compete with Indian commodities in the markets of the world and seriously affect India.

(i) The most important country in this category was China which took from India a large quantity of manufactured commodities. It was contended that, if the divergence between silver and the rupee became considerable, more rupees would be necessary to buy the same units of commodities as before, quoted in silver price. Besides, the cost in rupees to the Indian manufacturer of cloth, for example, would be greater as compared to that in China. Suppose, for instance, in India 100 units of cloth were equal to 100 units of silver. Under the new conditions, to produce these 100 units the cost in rupees would be greater. This would mean a great loss to the Indian manufacturer, who could not so quickly diminish his rupee cost of production. Thus, trade would be less profitable and its volume would be diminished.

But the Committee stated that the Indian produce imported into China *was paid for ultimately by goods* exported by China to other countries, and that, *if the gold price of these commodities did not fall* owing to a fall in the gold value of silver, they would realise a *higher silver price,* and that China would thus be able to pay a higher price for the Indian imports.

(ii) It was further argued that, if a great divergence between silver and the rupee took place, India would *lose her trade* in competition with silver-using countries *in other markets.* Thus, if there was a great divergence between the value of silver and of the rupee, a considerably lower gold price would, in China, represent the same amount of silver as before, whilst to India it would give fewer rupees. The Chinese would be content with charging the same silver price as before, but the Indian producer must be satisfied with a lower rupee price, or perhaps be driven

out of the market altogether through the stress of competition.

The Committee granted that in this case the Indian producer would suffer a great loss until *wages and other elements of cost of production had adjusted themselves to the new level of prices,* and that *the interval must be considerable* before such adjustment could be effected, for India's industrial institutions were but little developed. But they concluded that "consideration of the experience derived from the study of the history of Indian exports during the period characterised by a fall in the gold value of silver, leads us to doubt whether the suggested advantage is not so much less than those who urge the argument suppose."

(*b*) *Supposing the ratio were to be raised materially above the present level* :

The suggestion of the Government of India was that no ratio should be fixed immediately on the closing of the mints. Their proposal to own power to declare that English gold coinage shall be legal tender in India, at a rate of *not less than* 13⅓ rupees to the sovereign, would, if acted upon, prevent the exchange from rising to any great extent above 1*s.* 6*d.*

But the Committee stated that all the objections which were considered in (*a*) were at least equally applicable in this case, but the answers were not equally forcible.

The dangers of spurious coinage and of depreciation of Indian hoards *must increase* in proportion to the difference between the value of the rupee and the market value of silver.

Besides, trade difficulties due to a rising exchange, such as they were then, would, of course, be the greater the higher the ratio were taken.

(IV) POSSIBLE MODIFICATIONS OF THE PROPOSALS OF THE GOVERNMENT OF INDIA AND RECOMMENDATIONS OF THE COMMITTEE :—If, therefore, the scheme was to be modified it should remove the various risks and inconveniences that were likely to arise by the change.

THE POSSIBLE DANGERS TO BE AVOIDED :—(1) In the first place, the cessation of free coinage would, in all probability, be immediately followed by *a fall in the price of that metal.* If at the same time the exchange had risen considerably, the divergence between the rupee and its intrinsic value would become at once marked, and the *difficulty of maintaining the*

rupee at its higher exchange value might be increased and the apprehensions of disaster would be intensified.

(2) Moreover, the rise in exchange would be calculated *to lead to a fall in the price of Indian produce.* And, if this were seen to follow, and believed to be caused by the action of the Government, public opinion might be disturbed and the situation might become critical.

These, then, were the dangers to be avoided and the scheme was to afford *security against any sudden and considerable rise of exchange.*

THE REMEDY AND ITS BENEFITS :—But what was to be the remedy adopted ? It was to be provided that the mints (i) should be closed to the public for the coinage of silver, but (ii) *should be used* by the Government for the coinage of rupees if required by the public in exchange for gold, at a ratio to be fixed in the first instance *not much above the one prevailing, say*, 1*s.* 4*d.* to the rupee.

By such a measure the fall in the price of silver could be controlled to some extent, as the demand for silver on the part of the Government would *still continue.* It would be a less violent step than the closing of the mints altogether. Besides, the currency would not cease to be automatic.

THE RECOMMENDATIONS OF THE COMMITTEE :—The Committee, *on these grounds,* therefore, made the following recommendations : (1) that the closing of the mints to the free coinage of silver should be accompanied by an announcement that though closed to the public, they would be used by the Government for the coinage of rupees in *exchange for* gold at a ratio to be then fixed, say, 1*s.* 4*d.* *per rupee* ; and (2) that at the Government treasuries *gold would be received* in satisfaction of public dues at the same ratio.

RESULTS :—The following results ensued from these recommendations :—

(*a*) The mints were to be closed to the free coinage of both *silver and gold,* because by the Act of 1870 both silver and gold were received at the mints and coined, although gold coins were not declared legal tender.

(*b*) The rupee was made a *token coin,* since its exchange value was kept greater than its intrinsic value and a limit was put to its coinage.

(*c*) Besides, no specific provision was made for the introduction of a gold standard, although it was contemplated to establish a gold standard in the future. They expressed the opinion that a *transition period was necessary* in which the rate of exchange would be brought up to 1*s*. 4*d*. When this was achieved a gold standard would be established. That no provision was made for the future establishment of the gold standard was emphasized by Lord Farrer and Lord Welby, who wrote in a supplementary note, "A reserve (of gold) should, we contend, be provided before the Indian Government takes the final step of announcing gold as the standard, coupled with the correlative obligation to give gold for silver."

CHAPTER XVI

History during the years 1893-1900

1893–1900

Section I	Section II	Section III	Section IV
Act of 1893	1893-1895	1895-1899	Report of Fowler Committee and Gold Currency for India
Closing the mints to gold and silver	Continued fall of silver (The causes)	Raising the rate to 1s. 4d. by contraction of Currency	

Section I—Closing the Mints to the Free Coinage of Silver and Gold

THE COINAGE ACT OF 1893 :—The recommendations of the Herschell Committee were accepted and Act VIII of 1893 was passed on 26th June of the same year by which the *mints were closed to the free coinage of both gold and silver,* Government retaining the right to coin silver rupees on its own account. Three notifications were also issued at the same time by which (1) gold coins and gold bullion were to be *received at the mints* in exchange for rupees at the rate of 7.53344 grains troy of fine gold for one rupee, (*i.e.,* 1*s.* 4*d.* per rupee) ; (2) sovereigns and half-sovereigns were to be *received* in payment of sums due to Government as the equivalents of Rs. 15 and Rs. 7-8 as. respectively ; (3) currency notes were to be issued in exchange for gold coin or bullion at the same rate.

ITS INHERENT DEFECTS :—This legislation manifestly presented certain inherent defects. Whilst the Government of India was obliged to *receive gold* coins and gold bullion in exchange for rupees, it had *no obligation to give gold* in exchange for rupees. The obligation on the Government to coin silver rupees when the exchange was at 1*s.* 4*d.*, did not itself carry with it a corresponding obligation on the part of the Government to *give* gold for the rupees. This was its imperfection. Sir David Barbour himself held that, eventually, if the scheme were

to be successful, *gold when required must be given for the rupee,* either with a premium or at a small premium. "It is of course obvious that a great country like India, if she undertakes a token currency, is under an obligation to maintain its value, and that she ought to discharge that obligation by making it reasonably certain that, where gold is needed in exchange for rupees, it will be possible to obtain it at a fixed ratio."* In short, without this corresponding obligation to give gold for the rupees, it was questionable whether this gigantic token currency would be kept at par value for all times.

Suppose during a particular year the balance of trade became *unfavourable* to India owing to circumstances, such as a failure of monsoon. The exchange would, therefore, tend to fall. An unfavourable trade balance suggests that *more money is to be paid to foreign* countries than is to be received from them. In this case, therefore, the best method of keeping exchange at parity is to *give gold to Indian debtors* in exchange for rupees, to be exported to foreign countries. The result would be automatic ; rupees would be reduced in quantity in circulation and the amount of gold in circulation would increase, *i.e., less rupees would exchange with more gold than before in circulation,* the exchange value of the rupee would thus tend to be kept up to the original level. Besides, this would be a natural course for correcting the exchanges.

But in the system such a natural course was not provided for. The absence of gold to be made available for debtors was the great weakness of this system.

Section II—Continued Fall of Silver during 1893-95

The object aimed at by the closure of the mints was to give the rupee an artificially high value by making its supply scarcer relative to the demand for it.

But in the beginning circumstances were against such an artificial scarcity being created.

CAUSES OF FALL OF SILVER :—In the first place, there was already a great volume of rupees in circulation and the increasing imports of silver into India, led, during the year

* Lord Farrer and Lord Welby wrote in a supplementary note to the Report.

1893, to large issue of rupees from the mints and the total amount of rupees was sufficient to meet the requirements of the next few years.*

Besides, on November 1, 1893, America suspended the silver purchase clause of the Sherman Act, and, as the artificial demand for silver was cut off, the price of silver fell in consequence, and " no less than 37 per cent. of the world's annual production was dumped on the market."

Then, during the months July 1893 to February 1894, in order to liquidate the favourable balance of trade, *heavy imports of silver* came into India.

The rate fixed by the Act for the sale of Council Bills was 1*s.* 4*d.* per rupee. But at this time the Secretary of State sold the Bills at the market rate which was ***much below*** 1*s.* 4*d.* This led the people to believe that the Government could not raise the rate of exchange and caused great inconvenience. It was, therefore, decided by the Secretary of State that, to allay fears, the Bills would be sold at the minimum rate of 1*s.* 3½*d.* per rupee, which was higher than the market rate then existing. The debtors in England would not, therefore, buy the Bills and preferred as an alternative to remit silver to India. This, then, led to a considerable import of silver.

All these causes combined together to bring about a fall in the rate of exchange. The following figures show the extent of the fall of silver and of exchange.

Year	Intrinsic value of rupee as silver bullion		Average exchange value of rupees	
	s.	*d.*	*s.*	*d.*
1892	1	3¼	1	3¼
1893	1	1⅝	1	3⅛
1894	0	11⅛	1	1½
1895	0	11⅜	1	1⅜
1896	0	11⅞	1	2½
1897	0	10½	1	3¼
1898	0	10⅜	1	3⅞
1899	***0***	***10⅞***	***1***	***4***

* Findlay Shirras: *Indian Finance and Banking*, page 144.

Section III—Contraction of Currency and raising Exchange to 1s. 4d.

WHY EXCHANGE CONTINUED TO FALL? :—We now reach the period during which the rate of exchange was steadily raised until it reached 1*s*. 4*d*., the prescribed limit, but as the figures in the above table show, it was not till 1899, that this was done. The relative scarcity of the supply of rupees, as compared to the demand for them, could not be clearly felt until 1899 and this was due to various circumstances.

The years 1896 to 1898 were bad years for India. The country was in the grip of famine and plague, and her production of food-stuffs and materials was reduced and with it their exports to foreign countries.

At the same time, the foreign demand for Indian products fell, as most European countries were experiencing a severe depression of trade. India could not, therefore, enjoy her usual favourable balance of trade.

CONTRACTION OF CURRENCY :—But with the recovery in trade the exchange was raised to 1*s*. 4*d*. by the contraction of currency. That the volume of currency was contracted during this period is proved from the following facts :—

(1) In the first place, there was a decided *increase in the volume of business*, at the same time *the active rupee circulation actually decreased*.*

(2) Whether contraction of currency took place or not could also be evinced from the *discount rates* charged by banks to their customers. If the rate charged by banks for demand loans rises, it indicates that demand for money is greater than its supply, *i.e.*, stringency exists in the money market. Since the average discount rates of the Presidency Banks during 1898, rose to 8 per cent. as against 4 per cent. in 1893, it indicated that contraction of currency must have taken place.

(3) If the general level of prices fell, it would show that contraction of currency must have taken place, *i.e.*, if *less* rupees exchange with the *same* number of commodities or more commodities than before, the purchasing power of the rupee would be raised, or there would be

* Mr. Findlay Shirras in his *Indian Finance and Banking* (pages 161-167) proves this conclusively. He shows that in 1900 (as compared with 1893), (1) at the same time that the volume of business increased 39 per cent. the volume of active circulation decreased by nearly 4 per cent. and (2) even if the total circulation of rupees, notes and cheques is considered, it shows an increase of about 21 per cent. as against the increase in business of 39 per cent.

a fall in the general level of prices. The statistics of prices during this period indicate that contraction of currency must have taken place.

YEAR	INDEX NUMBER
Average of 1868-76	100
1897	149
1898	122
1899	117

Had the monsoon not failed in 1896, the fall in prices would have been continuous.

THE GOLD NOTE ACT, 1898 :—In 1898 an Act was passed to give elasticity to the currency. It authorized the issue, at the same rate, of *Rupee-notes in India against gold deposited in London* with the Secretary of State and earmarked at the Bank of England as part of the Paper Currency Reserve.

Section IV—Report of the Fowler Committee

GOVERNMENT OF INDIA'S DESPATCH OF MARCH 1898 :—It was stated above that the Government of India had to wait for five years before the exchange could be raised to 1s. 4*d*., and when in the beginning of 1898 the rate seemed to reach the stipulated limit, they thought that it was desirable in *the interests of the State and of mercantile community*, which had suffered so long from evils of an unstable exchange, to *terminate the period of transition* without further delay. They, therefore, sent a despatch in March 1898, to the Secretary of State, details of which we shall presently consider. The Secretary of State appointed in April 1898, a Committee presided over by Sir Henry Fowler to consider the proposals of the Government of India, and various schemes put forward by individuals, and to make their own recommendations for the establishment of a satisfactory system of currency in India. In July 1898, the Committee gave its report. A study of their report will be made into convenient parts.

PART I—Consideration of the Indian Government's Proposals

PROPOSALS OF THE GOVERNMENT OF INDIA :—In their despatch of March 1898, the Government of India emphasized the importance of *terminating the period of transition* without delay. But in order to achieve this purpose, they proposed as follows :—

(*a*) The first step proposed was to take powers to *borrow* sums not exceeding £2 crores in England and to remit to India ¼ of this amount in sovereigns to form the first instalment of a *gold* reserve to be established for the *future establishment of the gold standard.*

(*b*) Then nearly Rs. 2.40 *crores*, the estimated redundant amount, were to be withdrawn from circulation and were to be *melted down* to raise the gold value of the rupee.

(*c*) And the silver bullion obtained by melting down these rupees was to be sold off for *gold* which would be an addition to the gold reserve.

These measures, in short, were suggested to keep the exchange value of the rupee at a steady level of 16*d.* Thus, if the exchange fell below 16*d.*, the Government of India would adopt the following procedure :—First take rupees from its *balances*, melt them down, sell the bullion for *other rupees* in India, pay these other rupees into its balances, and the loss incurred by this process would be made good with the part of the borrowed gold.

As a result, it was anticipated that by the automatic operations of trade, gold would flow into India and remain in circulation. But, *gold was not to be made legal tender in India*, until exchange had reached 1*s.* 6*d.*

THE COMMITTEE REJECTED THE PROPOSALS :—The proposals were based on the belief that the rise in exchange value of the rupee, subsequent to the year 1894-95, was due to a *contraction* of the currency relative to the demands of trade, and that the cause would continue to operate so long as the Indian mints were closed to silver.

The Committee pronounced their opinion *against* this belief. They stated, " it is not certain that there has been any contraction of Indian currency which has naturally affected the

exchange. . . . On the other hand, there are causes other than contraction of currency."

Besides, they stated : "though we accept in principle the proposition that a reduction in the number of rupees tends to increase the value of the rupees, we are not prepared to admit that such effect must necessarily be direct and immediate, nor are we satisfied that such reduction, carried out on a large scale and within a limited period, might not aggravate, if it did not produce, a *period of stringency* in the Indian money market." That such a stringency would be created was also emphasized by the commercial classes of India. Therefore, the proposals would not inspire confidence into them.

In their proposals the Government of India showed great anxiety to terminate the period of transition without further delay. They described this transition stage as the stage of distrust, which would be passed the moment exchange reached 16*d*. per rupee.

But, since they wrote in March 1898, there had been a marked improvement in the position. The exchange was steady at or about 1*s*. 4*d*., the drawings of the Secretary of State had been unusually large, and a substantial sum of over £2,370,000 in gold had been brought to the Indian Treasury, *i.e.*, the stage of distrust, which had interfered with the actual realization of a rate of 16*d*., had been already passed.

On these grounds, therefore, the proposals were rejected by the Committee.

PART II—Should the Mints be reopened to Silver?

Various persons had represented to the Government of India that the Indian mints should be reopened to the unrestricted coinage of silver either immediately or gradually, *i.e.*, India should have Silver Monometallism. The Government of India, on their part, pronounced their opinion *against it*, but asked the Committee to consider the question.

THE ARGUMENTS SUGGESTED IN FAVOUR OF RE-OPENING MINTS :—The chief arguments in favour of re-opening the mints brought forward by its supporters were :—

(*a*) that the system of closed mints handicapped India in her industrial competition with countries on a silver standard ;

(*b*) that " a low Rupee and a low exchange " would encourage the export trade on which India's prosperity depended and that an " arbitrarily enhanced " Rupee discouraged exports.

THE COMMITTEE REFUTED THEM :—This aspect of the question was considered by Lord Herschell's Committee which had expressed its opinion that " even if we assume the argument as to a stimulus or check to production to be sound, the effect of each successive fall in exchange must be transitory and could only continue until circumstances have brought about the inevitable adjustment."

In this opinion, the Fowler Committee concurred. Besides, they too, were unable to find any statistical support for the theory that exports are largely and permanently stimulated by a depreciation of the standard of value, resulting in a fall in exchange, and they concluded that the statistics of the Indian export trade since 1893 were no good guide in deciding this question, for their value for this purpose was much diminished by the *special disturbing influences* to which that trade had been subjected since that date.

Further, the Committee recognized that fluctuation of exchange constituted an obstacle to international trade, and wrote, " since over *four-fifths of India's seaborne foreign trade is with gold-standard* countries, it follows that the balance of advantage is heavily in favour of stability of exchange with gold standard countries ; and accordingly, considered by itself, the instability of exchange which must be anticipated from reopening the Indian mints to silver, is a powerful argument against taking the step ". They emphasized that it was not in the permanent interests of India, that her foreign commerce, over 80 per cent. of which was with gold standard countries, should be hampered by the restoration of silver monometallism.

In view of these considerations, the Committee concurred with the Government of India in their decision not to revert to the silver standard.

PART III—The Principle of a Gold Standard

The practical alternative to silver monometallism was a gold standard, *i.e.*, gold as the measure of value in India, either with a gold currency or with a gold reserve, and the Committee laid down certain advantages which India was to derive by adopting gold as the *measure of value*.

ADVANTAGES TO INDIA OF A GOLD STANDARD :—(*a*) In the first place, they referred to the fact that over four-fifths of the foreign trade of India was with gold standard countries, and that for the same reason it was desirable that India should have the same measure of value as those countries. Regard being had to the supremacy of gold in international commerce, the change to a gold basis would facilitate interchange of commodities.

(*b*) A further and certainly not a less important consideration pointed out for a country like India was that an established gold standard was the simplest and most effective means of *attracting capital*. The need for foreign capital was indisputable, and this need was partly of a temporary and partly of a permanent character. For climatic reasons, India has been essentially a country of seasonal trade ; she has had a busy season and a dull season. From this seasonal character, it followed that the demand for money has been much greater for one part of the year than for another. In the busy season, there has been a brisk demand for money for temporary advances to move crops ; in the dull season money has been in little demand. This led to great seasonal variations in discount rates and to great *stringency* during the busy season.

In order, therefore, to diminish the risk to Indian commerce of a recurrence of such stringency, and in order to reduce the average rate charged for the local use of money, they recommended that the soundest policy was *to attract capital to India from the gold standard countries* which had capital to lend, and this could best be achieved by a *gold standard* and a stable exchange.

Besides, in order to develop and reap the benefit of her natural resources, India required, and must long continue to require, foreign capital. Such capital could only be drawn from the gold standard countries, and the capital of these countries

could only be attracted by a moderate rate of interest or profit, on condition that the investor was satisfied, that there was not likely to be a fall in the sterling exchange.

WAS ACCUMULATION OF SUFFICIENT GOLD POSSIBLE ? :—The next question to be solved by the Committee was whether it would be practicable to have sufficient gold for the establishment of a gold standard. The Government of India pointed out that it was extremely unlikely to accumulate sufficient gold for the purpose, but the Committee proved by statistics that it was otherwise. At this time, when they considered the question, the amount of gold in the Paper Currency Reserve was £2,378,609 which was considered as a substantial addition to the Indian currency. Besides, by the sale of Council Bills the Government of India was able to remit, without disturbing the money market, nearly £18,712,454 worth gold to the Secretary of State.

If such results could be secured in the face of mistrust, it was argued that even greater success might be expected in the future with the growth of confidence. The question, therefore, arose : Should the *status quo* be allowed to continue until events forced the Government to take action ? The Committee declared itself against the *status quo*. To have matters as they were, specially after the Government of India had formulated proposals to curtail the transition period and had aroused public opinion on them, would be to create additional uncertainty and withdrawal of confidence in Indian monetary future.

On these grounds the Committee recommended the *effective* establishment of a gold standard.

PART IV—Should there be a Gold Standard without a Gold Currency ?

The Committee then considered two schemes which were proposed for establishing a gold standard *without* a gold currency.

(1) MR. LESLEY PROBYN'S SCHEME :—Mr. Lesley Probyn laid great stress upon the *hoarding habits* of the natives of India ; and in view of the direct encouragement which a gold currency might give to the hoarding of gold, he represented before the Committee that, "if gold coins were passed into

currency, it would be at first like pouring water into a sieve." Accordingly he proposed :—

(i) to issue such notes only in exchange for gold ;
(ii) to institute a separate issue of ***gold notes*** of the denomination of Rs. 10,000 ;
(iii) to make them payable (at the option of the holder) either in rupees or in gold ;
(iv) to make it optional to the currency department, when gold is demanded, to pay either in sovereigns or in gold bars of not less than £67 ;
(v) to issue notes of ***smaller denominations*** as usual, but these were to be redeemable in ***silver rupees only.***

By this scheme it was hoped that gold would be attracted to India, and that a gold reserve would be gradually accumulated which would be strong enough to allow the Government to undertake ultimately the universal convertibility into gold of all rupees and rupee-notes, when presented in parcels of not less than Rs. 10,000. Under this scheme the gold standard would be left to automatic agencies to establish itself, and its establishment would coincide with an ultimate undertaking to exchange rupee currency for gold bars of high value.

THE COMMITTEE REJECTED THE SCHEME :—The Committee pronounced its opinion against this scheme.

In the first place, as regards the hoarding difficulty in India, they were not satisfied that the danger therefrom was so great as was suggested. *Even under silver monometallism India imported and absorbed gold and would be expected to do so in the future, no matter what her system of currency.* In a strongly conservative country like India, no sudden changes were to be expected in the habits and customs of the people, particularly as regards currency and hoarding. And, until gold had penetrated into general circulation (so far as the relatively small transactions of India permitted), there would be no materially increased temptation to the people to hoard gold instead of silver.

Secondly, the introduction of a gold currency into India was *not to be an untried experiment.* Gold coins were in common circulation in India even before 1835 and formed the principal currency of various parts of the country. "If hoarding," they

wrote, "did not render a gold circulation an impossibility in the past, we look for no such result in the future. *The hoarding habit, in short, did not present such practical difficulties as to justify a permanent refusal to allow India to possess a gold currency.*"

Thirdly, while bullion was an admitted international medium of exchange, there was, according to the Committee, no precedent for its permanent adoption for purposes of internal currency, nor did it accord with either European or Indian usage that the standard metal should not pass from *hand to hand* in the convenient form of current coin.

(2) MR. A. M. LINDSAY'S SCHEME (THE GOLD EXCHANGE STANDARD): ITS CHIEF AIM:—Mr. A. M. Lindsay, Deputy Secretary of the Bank of Bengal, suggested a scheme of currency which would do away with a gold currency. His chief aim was to propose such a scheme that, when it was found necessary to prevent the rupee from *rising above specie-point*, the rupee currency could be *expanded*; and when it was found necessary to prevent the rupee from *falling below specie-point*, the rupee currency could be *contracted*. In short, the system was to be automatic in order to keep exchange steady.

We have already seen that the Act of 1893 made provision for preventing the rupee from rising above 1*s*. 4*d*. by making it binding on the Government to give rupees in exchange for gold or gold sovereigns; but that no provision was made to prevent exchange from falling below specie-point. *Mr. Lindsay's aim was to remove this deficiency by compelling the Government of India to give sterling (and not gold) in exchange for rupees.*

The essentials of the scheme:—(1) A loan not exceeding £10,000,000 was to be raised in London and the amount was to be kept as a gold standard *reserve* in an office called the London Gold Standard Office.

(2) The Government of India would sell to applicants in India *sterling drafts* on London for not less than £1,000 at the rate of 1*s*. $3\frac{3}{4}$*d*. per rupee, and these were to be paid from the reserve located in London.

(3) On the other hand, the London office would sell to applicants in London rupee drafts on the Indian offices for not less than Rs. 15,000 at the rate of 1*s*.$4\frac{1}{16}$*d*. per

rupee, and these were to be paid in rupees at Calcutta and Bombay.

(4) If an excess of rupees accumulated as the result of selling drafts (*i.e.*, if the reserve in London were depleted) the excess would be sold as bullion and the proceeds to be credited to the reserve in London ; if, however, the stock of rupees were insufficient in India, silver would be purchased out of the London reserve and sent to India to be coined in rupees.

Thus, if at a particular time contraction of currency was found to be necessary to keep exchange steady, sterling drafts would be sold in India for rupees, and rupee currency would be consequently withdrawn from circulation ; if, on the contrary, expansion of currency was necessary, rupee drafts would be sold in London which would be paid for in rupees in India, so that rupee circulation would be increased.

It may be noted that rupees were to continue to form the circulating medium in India, gold not being admitted to legal tender.

THE FOWLER COMMITTEE REJECTED THE SCHEME : The Fowler Committee rejected this scheme more or less on the same ground as Mr. Probyn's bullion scheme. "It is evident," they wrote, "that the arguments which tell against the permanent adoption of Mr. Probyn's bullion scheme and in favour of a gold currency for India, tell *more strongly against* Mr. Lindsay's ingenious scheme for what has been termed '*an exchange standard*'." The Committee were impressed by the evidence of Lord Rothschild and others that *any system without a visible gold currency would be looked upon with distrust.* In face of this expression of opinion they concluded :—

(1) that the adoption of Mr. Lindsay's scheme would *check that flow of capital to India* upon which her economic future so greatly depended ;

(2) that, if any system were to be permanent, it would base India's gold standard for all time *on a few millions of gold* (or rather command over gold) in London, with a liability to pay out gold in London, in exchange for rupees received in India, to an indefinite extent.

This was the main reason which made the Government of

India* reject the scheme and the Committee found full justification for their decision.

PART V—Recommendations of the Committee

We have now to consider the recommendations of the Committee.

(A) GOLD CURRENCY FOR INDIA :—Their most important recommendation was that the *British sovereign* should be made a legal tender and a current coin in India. They considered that, at the same time, the Indian mints should be thrown open to the *unrestricted coinage of gold* on terms and conditions such as governed the three Australian Branches of the Royal Mint. The result would be that, under identical conditions, the sovereign would be coined and would circulate both in England and in India.

Thus, the *sovereign* was to be the *standard coin* of India. "Looking forward as we do to the *effective establishment in India of a gold standard and currency based on the principles of the free inflow and outflow of gold,* we recommend these measures for adoption."

(B) CONVERTIBILITY OF THE RUPEE :—But under an effective gold standard the rupee would become a *token coin,* subsidiary to the sovereign. In principle the existence of token coins postulates that they should be *limited legal tender.*

(1) In the case of the rupees the Committee decided that conditions then prevailing in India did not warrant the imposition of a limit, *i.e.*, they were to be left unlimited legal tender. They stated that, if there were a limit placed on the *total issue of rupees* in circulation, it would make the rupee permanently exchangeable for gold at a fixed rate, and consequently there would be no necessity of making the rupee limited legal tender. The experience which had been gained since the closing of the Indian mints to the free coinage of silver supported the belief

*Other arguments against the scheme were stated by Sir James Westland, the Finance Member, who in a minute to the despatch of the Government of India wrote: (1) that a gold reserve intended to support the introduction and maintenance of a gold standard in any country ought to be kept in the country, if it is to produce its full effect in the way of establishing the confidence which is almost indispensable to the success of the measure. If the Indian gold reserve is located in London and the public believe that it may at any time vanish in supplying the requirements of trade or of the Secretary of State, confidence will hardly be established; (2) that the scheme did not provide for sufficient control over the exchange.

that this result could be attained.

They quoted two principal instances of countries with a gold standard and currency, which admitted silver coins to *unlimited* legal tender. These countries were France and the United States of America, which did it successfully by keeping their mints closed to the free coinage of silver. The special difficulty in the case of India was one of degree and not of principle.

They, therefore, thought that keeping the Indian mints closed to the free coinage of silver was an *adequate restriction*, and that it made it unnecessary to put any limit on the amount for which tokens were a tender by law.

(2) They recommended that as the principal use of the gold reserve was that it should be freely available for *foreign remittances when the exchange fell below specie-point, the Government of India should make its gold available for such a purpose, when a necessity arose for its export.*

(3) Besides, the Government should continue to *give rupees* for gold, but fresh rupees should not be coined until the proportion of gold in the currency was found to exceed the requirements of the public.

(4) Finally, in order to have sufficient gold for making it available to the public for export, they recommended the formation of *a gold reserve*. They wrote, "We also recommend *that any profit on the coinage of rupees should not be* credited to the revenue or held as a portion of the ordinary balance of the Government of India, *but should be kept in gold as a special reserve* entirely apart from the Paper Currency Reserve and the ordinary Treasury balances."

(C) THE STERLING RATE FOR THE RUPEE :—The Committee, excepting two of its members,* recommended that the ratio should be 1*s*. 4*d*. per rupee on the following chief grounds :—

(i) that it was the rate then prevailing and that the continuance of the existing arrangements, under which no fresh rupees were coined except in exchange for gold at a fixed rate, must tend more and more to establish the exchange at that rate ;

* Two out of the eleven members of the Committee, Messrs. Robert Campbell and John Muir, recommended the 1*s*. 3*d*. per rupee rate.

(ii) that in 1898-99 at 16*d*. rate of exchange, as we have pointed out, an enormous volume of export trade was achieved without any monetary stringency and a sufficient amount for the gold reserve was accumulated ;

(iii) that prices in India might be assumed to have adjusted themselves to 16*d*. rate and that there was no sufficient reason for altering the existing relations of prices and the essential conditions of contracts expressed in Indian currency.

Thus, they concluded that experience gained since 1893, and particularly that of the eighteen months before writing the report, appeared to them to justify the anticipation that the 1*s*. 4*d*. per rupee rate possessed elements of permanent stability and would be maintained in the future.

SYNOPSIS OF THE RECOMMENDATIONS :—The main recommendations of the Fowler Committee were the following :—

(*a*) that the *British sovereign* should be made a legal tender and a *current coin in India* and that Indian mints should be thrown open to the unrestricted coinage of gold. Their real object was the *effective establishment in India* of a *gold standard and currency based on the principles of the free inflow and outflow of gold ;*

(*b*) that Government should continue to give rupees for gold but *fresh rupees should not be coined until the proportion of the gold in the currency was found to exceed the requirements of the public ;*

(*c*) that any profit on the coinage of rupees should not be credited to the revenue or held as a portion of the ordinary balance of the Government of India but *should be kept in gold in India as a special reserve* entirely apart from the Paper Currency Reserve and ordinary Treasury balance ;

(*d*) that when the Government has accumulated a sufficient gold reserve and so long as gold is available in its Treasury, *it might discharge its obligations in India in gold* instead of rupees ;

(*e*) that the relation of the sovereign to the rupee should be 1*s*. 4*d*. *per rupee* ;

(*f*) that the *rupee,* although made a token coin, should be kept *unlimited legal tender.*

CHAPTER XVII

Pre-War Period (A)—1900-1907

Departures from Fowler's Recommendations. (Drifting towards the Gold Exchange Standard)

THE ACT OF 1899 :—The recommendations of the Fowler Committee were accepted in their entirety by the Indian authorities and the Indian Coinage Act No. XXII of 1899 made the sovereign and half-sovereign legal tender throughout India at Rs. 15 to the £, and thus gave effect to its first recommendation. Active steps were also taken to give effect to the second recommendation of the Committee, *viz.*, the opening of a mint for the coinage of gold in India.

It now remains to consider the history of events since 1899.

(A) IDEA OF A GOLD MINT WAS DROPPED :—In the first place, a gold mint could not be instituted without the sanction of the Royal Mint, as the English sovereign was to be the standard coin in India. But far from giving the sanction, the British Treasury objected* to the establishment of a gold mint in India on various grounds. They did not think that sufficient gold would be available in India to enable the mint to continue for a long time, nor did they think it advisable to let the Indian Treasury bear the cost of the mint.

But apart from this technical difficulty, they questioned the very necessity of a gold mint for India. Besides events after 1899, which we shall presently show, went against its establishment.

(B) THE RECOINAGE OF SILVER :—The scheme was, therefore, dropped after nearing completion in 1902. In spite of the fact that gold coins were now legal tender in India, a curious situation arose. *The people continued to demand rupees, and the sovereigns returned to Government Treasuries.* Various causes conspired to bring this about.

There was, in the first place, the general monetary stringency. As no new rupees were coined after 1893, with the growth in business, the stringency was bound to be felt.

* **Wadia and Joshi**: *Money and the Money Market in India*, page 199.

Then there were the consequences of the Act of 1898.* This Act authorised the issue at the rate of Rs. 15 to the £ of notes in India against gold deposited in London and earmarked at the Bank of England as part of the Paper Currency Reserve. This additional issue of currency against gold tendered in London *added to the drain* on the *rupee reserves* of the Government of India.

In view of this drain, the Government of India made an active effort to induce the people of India to use sovereigns as a medium of exchange. The Currency Offices were instructed to offer sovereigns to presenters of notes, and to give rupees to those who objected to receive sovereigns; and, at the same time, the Post Offices and other institutions were utilised to press sovereigns on the public. But all was in vain. Many of the gold coins made their way back to the Treasury, and the Government found themselves unable to cash currency notes in rupees at various centres. Both notes and sovereigns became subject to a discount in many places.

Unfortunately, *famine* conditions also led to a special demand for rupees and aggravated the general monetary stringency. Sir Edward Law, the Finance Minister, laid great emphasis on the effects of famine on the demand for rupee currency. In his minute of 6th September 1900, he wrote, "the great bulk of the population is purely agricultural. The agriculturist, in ordinary times, has little requirement for money in the shape of silver coin; he is himself the producer of a large proportion of the food he consumes, and his other wants which must be satisfied by purchase are trifling. In seasons of famine, however, the situation is changed. The food consumed by the suffering agriculturist must be purchased and paid for with coin, and as credit dries up in times of distress all his other requirements must equally be paid for in cash." Under these abnormal circumstances the Government of India resumed the coinage of rupees early in 1900 on a considerable scale.†

* Chamberlain Commission Report, para 24.

† That gold returned to Government Treasuries under *abnormal* conditions and that gold currency would have been effectively established if time had been allowed for normal conditions to establish themselves, is proved from the confident statements made by Sir C. E. Dawkins in his Financial Statement for 1900-01. He stated, "I believe that the rate at which gold is taken is likely to increase slowly, and that gold will pass gradually into general circulation in our seaports and large towns. No expectation was ever formed, nor is there any reason to desire, that gold would penetrate into the interior, or that the large mass of transactions in the country would ever be conducted except through the medium of silver and copper. Gold is behaving very much as we anticipated."

(C) THE USE OF SPECIAL RESERVE WAS CHANGED. (The Gold Standard Reserve) :—The third recommendation of the Committee was that the profits on the coinage of rupees should be set apart and kept in gold as a special reserve. *The Gold Standard Reserve,* as it came to be called, was the outcome of this recommendation. The Government of India proposed the formation of a special reserve in September 1900. Sir Edward Law, the Finance Member, wrote a minute on 28th June 1900, and the principles he laid down therein, decided the future of the currency policy—the establishment of the Gold Standard Reserve. He proposed that—

(1) a maximum limit should be put on the gold in the Paper Currency Reserve, which was to be £7,000,000. Any excess over this amount should be utilized for purchasing silver ;

(2) a special gold reserve should be formed by the accumulation of entire profits on the coinage of rupees, apart from the Paper Currency Reserve and the balance of the Government ;

(3) the annual interest on the investment of the Paper Currency Reserve should be credited to the special reserve.

The idea seemed to have been to keep the reserve in gold locked up in a special chest in *India.*

(1) But the Secretary of State decided that the profits should be *remitted to London and invested in sterling securities.* It was held that, since London was the place in which the reserve would have to be applied on the occasion of the emergency against which it was created, London would be the best place in which to keep it.

For the first few years from 1901 onwards, the profits on the coinage of rupees were accordingly remitted to London for investment, the gold being taken out of the accumulation in the Paper Currency Reserve in exchange for the rupees freshly coined. The interest earned on the securities was also added to this gold reserve.

(2) In 1905 the sterling resources of the Government of India in London were further increased by the shipment to London of £5,000,000 out of the stocks in the Paper Currency Reserve in India, to be held as a part of that reserve in *London.* " The

advantage claimed of shipping these sovereigns and others in course of years to London and keeping them there was "that they could be used there, as and when required, in purchasing silver, thus saving three or four weeks' delay involved in shipping them from India at the moment when actually required."*

(3) In 1906 another innovation was made. The difficulty in meeting the demands for rupees led to the formation in India of a special reserve besides the Paper Currency Reserve. This reserve was to be in coined rupees and was to be formed from a part of the profits on the coinage of the rupees. Thus were formed two branches of the gold reserve, (*a*) in the form of rupees in India and (*b*) in the form of sterling securities in London. The name of this reserve was thereupon changed to the *Gold Standard Reserve* which consisted of these two portions.

(4) In June 1907, a Committee, known as the Mackay Committee, appointed by the Secretary of State to consider the question of Indian Railway Finance, recommended that £1,000,000 out of the profits on the coinage in 1907 should be devoted to the provision of adding rolling stock and other improvements for Indian railways, as there was very urgent need of development in that direction. But the Secretary of State went beyond their recommendation and decided that for the future *one half* of any profits on the coinage of rupees should be used for capital expenditure on railways until the Gold Standard Reserve reached £20,000,000. It was apparently contemplated that, after that total had been reached, all profits on the silver coinage should be diverted from the reserve. In spite of protest from the Government of India, he diverted £1,123,000, and adhered to his decision with regard to the future use of the profit on the coinage. But a serious crisis occurred in 1907-08 which made him change his decision.

(D) THE FUNCTION OF THE PAPER CURRENCY RESERVE WAS DIVERTED :—When the coinage of rupees had to be resumed early in 1900, recourse to the London silver market became necessary and silver was bought with the gold held in the Paper Currency Reserve in London. A provision authorizing the Government *to use the gold held in the Paper Currency Reserve* for the purchase of silver for coinage was included in the Act of 1898, which was continued for two years.

* The Chamberlain Commission Report, para 29.

But an Act of 1902 made the whole of these provisions permanent, although they were issued during times of emergency. Thus *the function of the Paper Currency Reserve,* of supporting the convertibility of the notes, was *diverted to that of buying silver for coinage.*

(E) GOLD DIVERTED FROM INDIA :—Meanwhile, the practice of shipping to London gold accumulated in the Paper Currency Reserve in India was recognized to be needlessly expensive. The gold, it was seen, reached India in the first place at the cost of individuals, and then had to be shipped back to London by and at the cost of the Government after the public had handed it on to the Government in exchange for rupees. If the practice of receiving gold in London in exchange for rupees in India were extended, Indian revenue could be saved the expense of shipping gold to London, and a large part of the cost of sending gold to India could be realized in the selling price of the Council Drafts.

(1) Accordingly the practice introduced in 1898 of selling the Council Drafts for gold in London, and issuing notes against such gold in India, was extended, and since 1904 the Secretary of State kept open a standing offer to sell Council Bills *without limit* (*i.e.,* over and above his requirements) at the price of 1*s.* 4⅛*d.* which was the normal gold export point from London to India.

(2) Moreover, the Secretary of State increased the sale of the Bills by selling them below the gold export point.

In normal times one of the methods of paying for India's favourable balance of trade was by the remittance of gold bullion and sovereigns to India. But by the limitless sale of the Council Bills, and their sale below gold export point, gold bullion and sovereigns were *prevented* from flowing to India.

SUMMARY :—*Thus the divergence made from Fowler's Scheme were as follows :—*

(1) The scheme for a gold mint was dropped.
(2) The recoinage of rupees was undertaken extensively during this period.*

* "The effects of heavy coinage are cumulative. The Indian authorities do not seem to have understood this. They framed their policy as though a community consumed currency with the same steady appetite with which some communities consume beer." (Keyne's *Indian Currency and Finance.*) This points to the fact that there was over-issue of coined rupees during this period.

(3) The location and use of the Reserve formed from the profits on the coinage of rupees were diverted :
   (*a*) The Gold Standard Reserve was invested in securities in London.
   (*b*) The silver branch of the Gold Standard Reserve was formed.
   (*c*) A part of the Gold Standard Reserve was diverted to the Railway capital expenditure.

(4) Council Bills were sold without limit, and at times, at something below gold point against the currency reserve, thus preventing gold from flowing to India.

(5) The gold of the Paper Currency Reserve was used to buy silver for coinage.

Period (B)—1907-1914

PART I—The Crisis of 1907-1908

(and the completion of the Gold Exchange Standard)

GOLD STANDARD RESERVE MAINTAINS EXCHANGE :—In 1907-8 various adverse circumstances led to a crisis in exchange in India ; and for the *first time* since the rupee was fixed at 1*s.* 4*d.*, the Gold Standard Reserve and the other sterling resources of the Government of India were utilised in maintaining *the exchange value of the rupee. Thus was completed the mechanism for the successful working of the Gold Exchange Standard.*

CAUSES OF THE FALL IN EXCHANGE :—During the year various causes brought about a fall in the exchange value of the rupee :—

The summer monsoon of 1907 had partially failed and our exportable commodities diminished as a consequence.

To this was added a serious financial crisis in America, which resulted in a general monetary stringency all over the world, and the Bank of England was actually compelled to raise its rate of discount considerably.

Both these causes resulted in a heavy fall in the demand for the Council Bills and for some months none could be sold. The Indian exchange began to fall steadily until it reached the lowest point : 1*s.* 3 $\frac{11}{16}$ *d.* (on 25th November).

WHAT SHOULD HAVE BEEN THE REMEDY ? :—What should have been the best remedy for strengthening a falling exchange ? The Government of *India should have given gold freely for export to* those who had to meet their liabilities in England. Those who needed gold would have paid for it in rupees, that is, rupees would have been withdrawn from circulation and gold would have come out of the reserves, and as a consequence, the exchange value of the rupee would have risen.

THE STEPS TAKEN BY GOVERNMENT OF INDIA :—But the steps taken by the Government in the beginning were different.

(*a*) The Government of India were asked by the Exchange Banks to sell telegraphic transfers on London at Rs. 15 to the £, but after consulting the Secretary of State they refused to do so.

(*b*) Then the Government of India refused to give gold from the Paper Currency Reserve for export in larger quantities than £10,000 to any one individual in one day.

(*c*) The British Postal orders for £10,000 and other large sums began to be bought as a means of obtaining remittance to London.

But the situation did not improve, and businessmen and banks continued to clamour for gold for export. Ultimately (it was not till 3rd December 1907), the Secretary of State was induced by the Government of India to permit them to give gold for export, although they continued to give gold for internal purposes.

(*d*) Although the normally busy season went on, rates remained weak and the situation did not improve, and it was decided on the 4th March 1908, to make weekly sales *in India* of a certain maximum quantity of *sterling bills* (or Reverse Councils) on *London* at the fixed rate of 1*s*. $3\frac{29}{32}d$. and on the 26th March 1908, such bills were first time sold. Meanwhile, the Secretary of State had taken steps to realise some of the securities belonging to *the Gold Standard Reserve* in order to have money ready to *meet the bills sold in India*. These Bills continued to be sold freely in India until (on 11th September 1908) the exchange appeared to have been sufficiently strengthened owing to a good monsoon, and the Government of India discontinued them.

Thus the mechanism of the Gold Exchange Standard was completed.

In all, £8,058,000 were withdrawn during this period from the Gold Standard Reserve to meet these Reverse Bills, and in India, by the sale of these Bills, more than Rs. 12 crores were withdrawn from circulation, in order to strengthen the exchange.

The total gold resources used in India and London together during this one year of crisis amounted to nearly £18,000,000.

THE LESSONS OF THE CRISIS :—The experience of the crisis taught various lessons, which had an important bearing on the future of Indian Currency.

The first serious lesson learnt was that the authorities had failed to recognise the wisdom of the recommendation of the Fowler Committee which was that the principal use of a gold reserve was that it should be freely available for foreign remittances whenever the exchange fell below specie-point.

The second lesson learnt was that the Government should formulate, in advance, the policy it intended to follow during a crisis, and give ample publicity to it. " It is almost as important that the general public should have confidence in the determination of the Government effectively to use their resources to maintain the rupee at 1*s.* 4*d.*, as it is that the Government should have the necessary resources for so doing."*

Besides, the crisis revealed the nature of the Indian Currency system, which was more like the system advocated by Mr. A. M. Lindsay in 1898 and which was rejected by the Fowler Committee. The machinery employed to establish the exchange value of the rupee based the system on what is generally known as the *Gold Exchange Standard.*

The rupee was established by this mechanism, *but the result was not obtained without considerable cost,*† *and the struggle imposed a severe drain on the gold resources of India.*

* Chamberlain Committee's Report, para 52.

† Howard: *India and the Gold Standard*, pages 35-36.

" In London the sovereigns in the currency chest were reduced from £7 millions to £1½ millions; Reserve securities to the value of £8,100,497 were put on the market, and all interest on investment was paid away as it accrued. In India the entire stock of gold was exhausted. In October 1907 when the trouble began, the currency chests, treasuries and mints held £4¼ millions of sovereigns. On March 31, 1908, the stock had fallen to £100,000 and all further issues had been stopped."

PART II—Currency Policy, 1909-1913

Gold Currency or Gold Exchange Standard for India?

We just saw above that the gold reserves of the Government of India suffered severely in the attempt to raise the exchange value of the rupee. This, therefore, aroused strong public criticism, and the Government of India found it necessary to revise the currency policy and entered into long correspondence with the Secretary of State over it.

POLICY PROPOSED BY GOVERNMENT OF INDIA (*A Gold currency*) :—The Government of India, on their part, wrote strongly in favour of the following :—

(*a*) In the first place, in their despatch of 1st April 1909, they pleaded for a *larger Gold Standard Reserve* to meet greater emergencies than that of 1907-8. They considered that the minimum amount in the Gold Standard Reserve should be £25 millions, apart from the gold in the Paper Currency Reserve and Treasuries and that, therefore, the profits on the coinage of rupees should not be diverted to the capital expenditure on railways until this limit was reached.

(*b*) They also proposed that a substantial bulk of the Gold Standard Reserve should be kept in a *liquid form*, instead of being invested in securities, because, during a crisis, the latter could not be readily realized and gold made available, or realized without considerable loss.

(*c*) The Government also urged the importance of ***holding a large amount of gold in India, and*** proposed that at least two-thirds of the total gold (£13,000,000) held in the Paper Currency Reserve, should be kept in India ; and that until this limit were reached, the Secretary of State should not add to the gold in the Paper Currency Reserve in London. In support of this, they wrote :—" Though gold was still far from having obtained that popularity which the interests of exchange render desirable, ***there were indications of a greatly extended use of the sovereign in commercial transactions***. It was estimated, for instance, by our Controller-General that it might shortly be possible to finance in *gold* no less than 20 per cent. of the up-country cotton trade of Bombay. This promising development has naturally received a severe check as a result of recent events. We, therefore,

judge it to be eminently desirable to increase the local gold holding in our Paper Currency Reserve. *We could face another exchange crisis with far greater equanimity could we be assured both of an active circulation of sovereigns in the country and of a strong reserve in our currency chest.* The former will enable the ready export of superfluous currency, which the strength of our own reserve would enable us at once to assist this process, and, by free uses of gold, to bring about that restoration of public confidence which is of vital importance in the early stages of a panic."*

(*d*) As an outcome of the resolution moved in 1912 by the late Sir Vithaldas Thackersey in the Imperial Legislative Council, the Government of India in their despatch of 16th May 1912, asked the Secretary of State's sanction for the *coinage of sovereigns* at the Bombay Mint.

THE SECRETARY OF STATE CHAMPIONS THE GOLD EXCHANGE STANDARD :—We have now to see how far these recommendations received the approval of the Secretary of State.

(A) As regards the amount of gold to be kept in the Gold Standard Reserve, the Secretary of State agreed, after great persuasion, that £25 millions should be the standard before the profits on coinage could be diverted.

(B) But he did *not* agree to the proposal to keep a substantial part of the Gold Standard Reserve in a liquid form, except for the amount £1 million, which he decided to let out in short loans or to put into bank deposits.

(C) As regards the strengthening of the gold in the Paper Currency Reserve and its location, the Secretary of State decided that it was more advantageous to *hold it in London* than in India. In support of this decision he stated that if the rate of exchange fell so low that it led to the suspension of the sale of Council Bills in London, gold in *circulation in India would be of little or no use for supporting exchange*, at any rate, immediately, since it would probably not be exported, and would obviously not be available towards defraying the Home Charges. On the other hand, he showed the advantages of holding gold in London and wrote :—

" Gold held in England is available for supporting exchange

* **Government of India's Despatch to the Secretary of State, 30th September 1909.**

not only when the rate falls to gold export point (when it can be used for meeting bills on London sold in India), but also at the earlier stage when the rate has fallen only to the point at which the suspension of Council Bills is desirable (when it can be used towards defraying the Home Charges). The stock is not liable to be depleted by any cause corresponding to the disappearance into hoards of gold in India. When the demand for remittances is strong, gold in England is available for any purchase of silver that may become necessary."

He, therefore, was unwilling to commit himself to a postponement of any increase of the stock of gold in England.

(D) With regard to the proposal for the minting of gold coins in India, the Secretary of State suggested the coinage in Bombay of a ten-rupee gold coin to avoid various difficulties that had arisen with His Majesty's Treasury. But the minting was postponed until the decision on it was given by the Chamberlain Commission, which had already been appointed.

CONCLUSIONS :—Two conclusions follow from these discussions on the currency policy :

(1) that, although the Government of India pleaded for a gold standard with a gold currency for India, *the Secretary of State decided in favour of the Gold Exchange Standard ;*

(2) that it was left for a Royal Commission to give its blessings to the Gold Exchange Standard by giving it permanency, and the *Chamberlain Commission was appointed.*

PART III—Findings of the Chamberlain Commission (1913-14)

(The Gold Exchange Standard was most suited to India)

The strong feeling in India with regard to the new currency policy evolved after 1899, and the difference of opinion between the Government of India and the Secretary of State on the same, meant that time was ripe for the establishment of a Royal Commission. A Commission was appointed in April 1913, with the Right Hon. Mr. Austen Chamberlain as the Chairman, and it reported in February 1914. Of the ten members of the Commission, one member of great practical monetary experience in

India, Sir James Begbie, wrote a dissenting minute entirely disassociating himself from the conclusions and recommendations of the majority.

Section I—Arguments in support of the Gold Exchange Standard

(1) In the first place, the Commission gave a summary of Indian Currency History from 1893 (which is not necessary to reproduce), and decided in favour of the continuance of the Gold Exchange Standard.

According to them, *force of circumstances* compelled the Government to evolve a new system, which was contrary to the one sanctioned by the Fowler Committee. The system actually in operation (the Gold Exchange Standard), they stated, had never been deliberately adopted as a consistent whole, nor did the authorities themselves appear always to have had a clear idea of the final object to be attained. To a great extent *this system was the result of a series of experiments*. But to state this was by no means to condemn the action or the system actually in force.

Then there was the admission that the authorities were subject to mistaken ideas which were quickly rectified in practice. But the steps taken to restore and maintain exchange had proved adequate.

Their argument was that the crisis of 1907-8 and subsequent experiences had proved that it would be possible to maintain the purchasing power of the Rupee *outside India* at Rs. 15 to the sovereign *without the aid of a gold currency circulating within India.*

SIR JAMES BEGBIE'S REJOINDER :—The Majority had pressed the point that the public preferred and demanded rupees, and the demand had to be met. This, in fact, had been the fundamental difficulty which led to the evolution of the new system of currency. But, Sir James Begbie pointed out that no doubt that was a reason which carried considerable weight in the early years of the period during which the policy had been developed, but "*it had now lost its force*". The *public had absorbed during the last* 12 *years, approximately, equal amounts* of rupees and sovereigns, but the demand for sovereigns had rapidly increased during the last four years. These gold require-

ments showed *an important* change *in the currency* needs of the people, and indicated a preference for *gold over rupees.*

(2) The second argument stated in support of the Gold Exchange Standard was that the Indian system so far evolved, had close affinities with other currency systems in some of the great European and Asiatic countries, *e.g.*, Russia, Holland, Austria-Hungary or Japan. In these countries, as in India, they stated, "*gold actually in circulation is of secondary importance*, and the internal medium of exchange, whether it be a silver coin or a paper note, depends for its value in exchange not on its own intrinsic worth, but on the maintenance in reserve of gold or resources readily convertible into gold, and in the case of Russia and Japan, at any rate, large portions of the gold resources are held not at home, but in London, Paris, and other monetary centres, just as India's Gold Standard Reserve is held in London."

SIR JAMES BEGBIE'S REJOINDER :—"But such analogies," wrote Sir James Begbie, "are unsafe as a guide to Indian policy, because the *conditions are not identical.* (*a*) In none of those other countries is there the same *private absorption of gold* that there is in India ; (*b*) whatever experience elsewhere may be, the recent demands for gold in India *show a loss of confidence on the part of the public in the token rupee,* and that is a situation that should not be ignored. The need for confidence to secure the exchange value of the rupee is recognized, but not the need of confidence in the currency in other respects. It is no longer possible to say that the token rupee is preferred by the Indian public and satisfies their currency requirements in face of the fact that they have latterly exhibited so strong a desire for gold as the *statistics indicate.* At least there is not now such general confidence in the Rupee as would, in my opinion, alone warrant further large extensions of the token currency."

(3) Another argument given by the Majority was that it was desirable "*to educate people in the use of more economical forms of currency than gold.*"

SIR JAMES BEGBIE'S REJOINDER :—"That is," wrote Sir James Begbie, "a desirable object. The increased circulation of notes may be pointed to as an advance towards the use of more economical forms of currency ; but it is due, not

solely to a desire to economise in currency, but partly at least to increased facilities for the employment of notes. This demand for gold coin, accompanied as it has been by increased demands for gold bullion, dominates the whole currency system. *For a country which takes gold in great quantities an extensive token currency is most unsuitable. It has the usual effect of driving gold out of circulation. It has the still greater disadvantage that it keeps the gold out of useful employment. People who value gold so highly as to store and hold it to the extent witnessed in India are not likely to invest or make other profitable use of it, so long as they have to take the risk of being repaid in token coins when they realise their investments.* The token currency not only prevents the holders of gold from utilising it to some advantage, but the country as a whole loses the benefit that should accrue to it from the possession of great wealth—What is needed is not education in the use of economical currency so much as *education in the use of stored up gold*. The first step, however, is to convince the people that if they use their gold they will get it back when they want it, and that cannot be done while there is this extensive and expanding token currency. A currency in which gold was a more prominent feature and to which token coins were less freely added would be more practical as an educative force."

Section II—Reasons advanced against Gold in Circulation

Having defended the existence and the working of the Gold Exchange Standard, the Majority in their report, gave careful consideration to various arguments put forward by witnesses in favour of gold in circulation. Since some of the arguments recur even to-day, it would be profitable to deal with them at length.

(*a*) The most weighty argument which several witnesses put forward was that *gold in circulation was calculated in the long run to strengthen exchange*. The Majority analysed this argument carefully as follows :—

(i) Some witnesses seemed to imply that, if gold were to be used in India to *the same extent as* in, say, the *United Kingdom or Germany*, the exchange problem would be largely simplified. In the opinion of the Majority, this was a mistaken belief.

Because in these countries the stability of exchange depended on the central reserves of the banks of these countries with their influence on other banks and the money market and their bank policy, and not on gold in the pockets of the people.

(ii) If, however, the advocates of gold currency desired that gold in circulation should be used to a *very great extent* as, for example, in Egypt, then the Majority considered that gold would be performing the function of strengthening exchange successfully. For in Egypt a large percentage of the value of the total transactions was carried out in gold, instead of a very small percentage as in the United Kingdom or India ; so that, in case of a contraction of business a nearly proportionate amount of gold would be released for export. But in order to attain to this position in India, it would be necessary to reduce the note issue to a comparatively insignificant position, and to withdraw from circulation, at large expense, a considerable part of the rupees.

(iii) If, however, the advocates desired *that gold should increase gradually* without detriment to the notes and rupees in circulation, the Majority declared that gold must continue to occupy, for many years to come, a subsidiary position in the currency, and exchange would not benefit materially from a circulation of gold on a moderate scale, as was proved by the crisis of 1907-8.

But the question would arise as *to the source* from which the gold was to come. If the gold took the place of new rupees, which it would be necessary to mint, the effect would be to diminish the strength of the Gold Standard Reserve by the amount of the profit which would have been made from the new coinage. This would bring to an end its natural growth. Besides, if gold were to replace notes and rupees in circulation, the consequence would be a rapid depletion of the Paper Currency Reserve which serves as a substantial aid to the Gold Standard Reserve. Thus, the weakening of both the reserves might gravely weaken the Government's position at a time of exchange difficulty, because "*sovereign for sovereign, gold in circulation is less effective than gold in reserve for supporting exchange.*"

SIR JAMES BEGBIE'S REJOINDER :—"That, of course, is true," wrote Sir James Begbie, "but it is equally true that *gold*

in circulation is a better protection for exchange than token coins. Gold in circulation can never endanger exchange stability. It cannot be too strongly emphasised *that danger lies in the token currency alone when unfavourable trade conditions prevail.* In the words of the Report (of the Majority) ' it is the surplus tokens and not the gold which will seek an outlet at times of weak exchange '."

(*b*) Various witnesses objected to the coinage of fresh rupees because of the danger to exchange of a very large circulation of tokens. But the Majority stated that in many respects *gold was a far more formidable rival to the note issue* than to rupees, " since for many purposes a coin of so high a value as the sovereign cannot possibly take the place of rupees. There is some evidence that the popularity of sovereigns did hinder the use of notes in certain parts of India. Whilst experience has shown that a public preference for gold, or alternately for notes, is largely a matter of habit and custom. To habituate a people, therefore, to the use of sovereigns is almost certain in the long run to *militate against the use of notes which is not a desirable goal.* Notes is a more desirable form of currency than gold coins."

SIR JAMES BEGBIE'S REJOINDER :—But Sir James Begbie wrote, " notes will usually be preferred to coin, whether gold or silver, for such purposes as bank cash reserves and for effecting remittances. If the use of notes for other purposes is endangered by a circulation of gold coins, because people prefer the latter, it has to be remembered that the notes may be affected by the growing demands for gold. If the public want gold they will get it whether they hold notes or rupees, and when they prefer gold they are not likely to be satisfied with notes, payment of which can be demanded only in rupees."

(*c*) Certain witnesses argued that gold currency was a necessary step towards what may be regarded as the ideal currency, *viz.*, paper backed by gold in reserve.

On this argument the Majority stated that history gave no support to the view that a paper currency could only be reached after a gold currency had been in circulation. " A paper currency, if readily encashable, is the most economical medium of circulation, and at the same time provides a readily available

reserve of gold for foreign remittances."

(*d*) It was also stated by many witnesses that until India had a gold currency in active circulation, India would continue to possess an artificial and *managed currency*, it being implied that a managed system is a bad system. The ideal with which this "managed system" was contrasted was the system of the United Kingdom where there was free coinage and the standard coin could be obtained *by any one* who took gold to the mint for coinage.

The Majority saw no value in this contrast. According to them there did not appear to be any essential difference between the power to import sovereigns at will and the power to have gold coined into sovereigns in India.

(*e*) Besides, the Majority also regarded gold in circulation as *wasteful*, because of the *wasteful habit of hoarding* prevailing in India. "The hoarding habit is sanctioned by the experience of centuries in India and by religious and racial laws and customs, and until the habit of banking takes the place of the hoarding habit as a means of securing and increasing savings, it would be wasteful to have gold in circulation."

SIR JAMES BEGBIE'S REJOINDER :—"The hoarding habit in India is indeed a difficult problem. Its recent development in increased demand for gold, and the possibility of its further expansion make it a question of the highest importance." But, said Sir James Begbie, "*that is to a large extent the outcome of the policy which has brought into existence token currency*. Up to the closing of the mints in 1893 to the free coinage of silver, the public had been accustomed for generations to *full-value* coins for their currency requirements and *they are not now prepared to hold their profits and savings in the form of over-valued rupees*. Hence their preference for gold, both coin and bullion. The habit is, therefore, not inevitable and is capable of being improved. The statistics show, on the one hand, that great progress has been made in attracting the cash reserves of the people into profitable investments, but on the other, they show a retrograde movement in favour of hoarding due to the *natural desire for solid security* which is not to be had in investments which are made in token currency. It is surely not to the interest of India to have its rapidly accumulating wealth diverted into idle hoards by the token currency policy."

Besides, *if the gold held in hoards in India was to be attracted into useful employment,* " it can be done only by providing security that when it is invested the investment will continue to represent gold, and be convertible into gold, by *means of a gold currency policy* in which the public will have confidence."

(*f*) The Majority also concluded that " India neither demands nor requires gold coins for currency." But this statement called for correction. The fact that India imported, apart from gold bullion, over £60,000,000 in sovereigns in the twelve preceding years (*i.e.*, almost as much as the value of the new coinage of rupees in the same period), clearly proved that India did demand and require gold coins. " The fact is that India now demands gold monetary tools as insistently as she used to demand silver tools ; and the reasons are obvious—a growing distrust in the token rupee, and a growing appreciation of the superior attractions of the sovereign as currency."*

Section III—Gold Mint for India was unnecessary

Various witnesses also advocated the institution of a gold mint for India.

Some witnesses recommended a gold mint on the ground that it would *facilitate a flow of gold to India.* But the Majority considered that this argument had lost its weight because gold did flow freely to India without this stimulus, and they doubted if more could have been attracted by mere facilities for coinage.

Others recommended it on the ground that the mere fact of gold being coined in India *would win public confidence* in the stability of the exchange value of the rupee.

But the Majority stated that this consideration had its force in 1899 and 1900, but the experience of 1907-8, the growth of the Gold Standard Reserve, and the whole trend of policy and opinion since 1898, showed how determinately and successfully the Government maintained exchange.

The idea of a gold mint was also pressed on the ground that it *would increase the amount of gold in circulation.*

The Majority considered that, even if it was thought in itself desirable, tke mere existence of a mint for the coinage of gold

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* *Indian Finance and Currency* (A note on the Report of the Chamberlain Commission) by Sir M. de P. Webb, para 40.

could not add to the amount of gold available for currency purposes. Nor was it possible that it would encourage gold to come out of the hoards in unfavourable seasons. Indeed, in times of famine and distress, gold did come out of the hoards, but the existence of a gold mint was not likely to increase it. It would come out even in exchange for notes or rupees in difficult times.

If, therefore, the Government of India were to *renew the notification,* withdrawn in 1906, *of their readiness to receive refined gold at the Bombay Mint in exchange for notes or rupees,* it would remove the only practical grievance which could be alleged against the present system in this respect and *would render unnecessary the opening of a gold mint.*

But the Majority stated that "if Indian sentiment genuinely demands it, and the Government of India are prepared to incur the expense, there is, in our opinion, no objection on principle either from the Indian or the Imperial standpoint, provided always that the coin to be minted is the sovereign (or the half-sovereign) ; and *it is pre-eminently a question in which Indian sentiment should prevail.*"

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS :—

I. *The Gold Exchange Standard was suited to India because* :

(*a*) the establishment of the *exchange value of the* rupee on a stable basis had been of the first importance to India ;

(*b*) *the measures adopted* for the maintenance of the rupee (although necessarily and rightly supplementary to, than in all respects directly in pursuance of the recommendations of the Fowler Committee) *worked well* in the crisis of 1907-8, the only occasion on which they were severely tested ;

(*c*) the most generally suitable media of internal circulation in India were rupees and notes, but the use of notes should be encouraged. The essential point was that the internal currency should be supported for exchange purposes by a thoroughly adequate reserve of gold and sterling.

II. *The Gold Standard Reserve should be strengthened* :

(i) There should be no limit fixed to its amount, and

profits on coinage should be credited exclusively to it.

(ii) A much larger portion of it should be in actual gold which should be raised to £15,000,000 and thereafter *one-half of the total reserve should be in actual gold.*

(iii) The rupee branch held in India should be abolished, the rupee being handed over to the Paper Currency Reserve in exchange for gold.

(iv) The proper place of the Gold Standard Reserve was London.

III. The Government should undertake to sell bills in *India* on London at the rate of 1*s.* $3\frac{29}{32}$*d.* per rupee whenever called upon to do so (in case of a fall in exchange).

IV. The Paper Currency system should be made more elastic.

V. *It would not be to India's advantage to encourage an increased use of gold, and gold currency was not necessary for India* because :

(*a*) the gold standard had been firmly secured *without a gold currency*, as the history of the last 15 years had proved it ;

(*b*) gold in circulation was wasteful ;

(*c*) gold in circulation was of little or no use in support of exchange ;

(*d*) India should be encouraged to develop economical habits in matters of currency ;

(*e*) India neither demanded nor required gold coins as currency.

VI. *A gold mint was neither required nor was considered necessary for India*, but if Indian sentiment genuinely demanded it, and the Government of India were prepared to incur the expense, there was no objection to it, provided that the coin minted was the sovereign (or the half-sovereign). It was, pre-eminently, a question in which Indian sentiment should prevail.

If, however, the decision was against the opening of a gold mint, *the notification of the Government's readiness to receive refined gold in exchange for rupees or notes at the Bombay mints should be renewed.*

CHAPTER XVIII

The War Period

Period I
First shock of the war up to end of 1916
Dislocation of trade and business

Period II
From end of 1916 to 1919
Abnormal rise in the rate of exchange and its consequences

FATE OF THE RECOMMENDATIONS OF THE CHAMBERLAIN COMMISSION :—The recommendations of the Chamberlain Commission were receiving the attention of the authorities but in the meantime the war broke out. The Government was, therefore, not able to show its approval of all of them and it was left to the war period to prove their worth. But action was taken on the following recommendations soon after the war broke out :—

(*a*) the abolition of the silver branch of the Gold Standard Reserve ;
(*b*) the steps to be taken in case of a fall in exchange ;
(*c*) the giving of facilities for the encashment of notes.

THE WAR PERIODS :—The history of Indian currency during the war may well be divided into *two* parts :—

Period I. The first period ends with the completion of the year 1916. During this period there was general dislocation of trade and business, as a result of the first shock of the war, with its attendant effects.

Period II. The second period begins with 1917 and ends in 1919. This is the period of revival during which, owing to various causes, the rate of exchange soared very high.

PERIOD I—From First Shock of the War up to the end of 1916 (Dislocation of trade and business)

THE EFFECTS OF PANIC :—The outbreak of war immediately caused, in India as elsewhere, a panic which led to a

general dislocation of trade and business of which the principal symptoms were :

(*a*) the weakening of exchange ;
(*b*) withdrawal of savings bank deposits ;
(*c*) a demand for the encashment of notes ;
(*d*) a run on Indian gold stocks.

THE MEASURES TAKEN :—(*a*) The weakening of exchange was met by the proved expedient of offering drafts in India on London, and between 6th August 1914 and 28th January 1915, Reverse Council Bills were sold to the extent of £8,707,000 (the Chamberlain Commission had strongly approved of this measure and recommended it for future emergencies).

(*b*) The net withdrawal of savings bank deposits in the first two months of the war amounted to Rs. 6 crores (out of a total of Rs. 24½ crores on 31st July 1914) and there were subsequent withdrawals up to Rs. 2 crores in spite of some recovery. The net withdrawals for 1915-16 amounted *to nearly Rs.* 8 *crores*. But, continuous payment restored confidence and the tide turned in 1915-16, and since that date deposits continued to increase with the result that the figure at the end of 1918-19 was Rs. 18¾ crores. There was also a run on the banks, but this proved of short duration.

(*c*) Some lack of confidence in the Indian note issue manifested itself at the outbreak of the war and resulted *in a net return of currency notes* to the extent of Rs. 10 crores, and there was consequently a substantial fall in the silver held in the Paper Currency Reserve. Thus,

PAPER CURRENCY RESERVE

DATE	AMOUNTIN RUPEES
31st July 1914	33.94 crores
31st December 1914 ...	29.87 crores

But from the spring of 1915 there was a steady increase of note circulation.

(*d*) There arose at the end of July 1914, a keen demand for gold in exchange for notes and between the 1st and 4th August

1914, the Government of India lost about £1,800,000 of gold. When precautions to discourage the withdrawal of gold proved unavailing, it became necessary on 5th August 1914, to *suspend the issue of gold to private persons.*

The disquieting symptoms, however, lasted only for a short time. With the return of public confidence, assisted by the readiness of the Government of India to meet all demands, the currency mechanism began to work smoothly.

PART II—From the end of 1916 to 1919. Abnormal rise in the rate of exchange and its consequences

It was not until the end of 1916 that acute complications arose in the sphere of Indian currency and exchange. These complications were so great and varied, and existed at such a critical time, that rarely has another country passed through such a period of strain in its currency history. It is, therefore, of great importance to trace in details the causes which led to various difficulties in currency matters and the measures taken to overcome them.

Section I—Causes of the rise in the rate of exchange

(*a*) FAVOURABLE BALANCE OF TRADE :—It was well known that the ability of the Government of India to remit to London the funds required for the payment of the Home Charges, and also the successful working of the Indian currency system, depended on the existence of a substantial balance of trade in India's favour. Even before the war began, India had enjoyed a series of remarkably prosperous years, and during war years that prosperity was continued, although it was slightly lesser than in the pre-war years.

Average of 5 years	Net exports of merchandise on private account
1909-10 to 1913-14	£52,237,200
1914-15 to 1918-19	£50,387,700

But, if we take into consideration the three years 1916-17, 1917-18 and 1918-19, when the Indian currency difficulties were

most acute, we find that the average balance of trade in favour of India was decidedly greater than that of the three years preceding the war, as the following Table shows :

Average of 3 years	Net export of merchandise on private account
1911-12 to 1913-14	£53,429,200
1916-17 to 1918-19	£59,601,100

This was due to the fact that supplies of foodstuffs and raw-materials were required for the use of the Allied Powers and the prices they realized were abnormally high.

There was also a *contraction in imports* concurrently with an increase in exports, because the productive power of the United Kingdom and her Allies was more and more completely absorbed in war industries. *It was only the rise in prices that maintained the value of import trade. Imports from the enemy countries ceased entirely.*

The large balance of trade indebtedness in India's favour resulted in the strengthening of exchange and *the heavy demand on the Government for currency.*

(*b*) EXCEPTIONAL DISBURSEMENTS :—*Other special causes were at work to intensify this demand.* India formed the base of important military operations in Mesopotamia, Persia and East Africa. The Government of India was called upon to provide funds for the payment of British and Indian troops engaged and for the expenses incidental to a modern campaign, and for civil expenditure in occupied territory. In five years this expenditure totalled £240,000,000. In addition to the above, arrangements were made for financing of purchase in India on behalf of certain dominions and colonies and for provision of rupee credits, amounting to Rs. 20 crores in 1917-18 and 1918-19 for American importers of Indian produce.

These exceptional disbursements created a heavy additional demand for Indian currency.

(*c*) HEAVY DECLINE IN IMPORTS OF PRECIOUS METALS :—The precious metals play an important part in the adjustment of India's favourable trade balance, but during the

war years there was a *heavy decline* in the imports of gold and silver.

TOTAL IMPORTS OF PRECIOUS METALS INTO INDIA DURING

5 years preceding the war ...	£ 120,242,000
5 years of the war	£ 35,984,000

Several factors contributed to the remarkable decline in the import of precious metals during the latter period.

The first, and by far the most important, factor was *the difficulty of obtaining gold.* The free market in London, on which India had been able to draw in the past, disappeared on the outbreak of the war. Restrictions on the export of gold were imposed by belligerent Governments desirous of maintaining their stocks of the metal for war purposes, and India was accordingly only able to obtain very limited quantities.

The dearth of gold created a strong demand for silver of which there was a great shortage of supply. The world's production of silver from 1914 onwards exhibited a marked decline from the production of the preceding years. Approximately three-quarters of the world's production of silver was mined in North America and Mexico, and the key to the shortage was to be found in Mexico due to political disturbances in that country.

The decline in the imports of precious metals *threw the burden of liquidating the favourable trade balance on the Government of India.*

(*d*) ABSORPTION OF RUPEES :—That there was heavy absorption of rupees during the war is shown in the following table :—

RUPEE (INCLUDING HALE-RUPEE) ABSORPTION

(In lakhs of rupees)

Annual average	Amount
1909-10 to 1913-14	8,78
1914-15 to 1918-19	22,08

It shows an *increase of nearly* 250 *per cent.* above the pre-war average.

(*e*) RISE IN PRICE OF SILVER :—At the same time, the *world's demand for silver was unusually keen,* particularly for coinage. The coinage of the British Empire alone absorbed nearly 108 million ounces during 1915-18, as against 30.5 million ounces between 1910-13. And there were similar increases in other countries, specially in China. Before 1917 China was a seller of silver, but since that year she became an intensive demander of that metal.

It was stated that war conditions interfered with the normal flow of precious metals into India. The burden, therefore, of liquidating her favourable balance of trade was focussed on the Government of India and took the form of *additional demands for currency*. The efforts made to meet these demands are indicated in the following figures :—

During period	Amount bought by Government of India in *standard ounces*
April 1904 to March 1907	180,000,000
April 1916 to March 1919	500,000,000

Consequently, these large purchases by the Government of India, the decrease in the supplies of silver and the increased demand from other quarters, *led to a rise in the price of silver.*

Year	Price of silver per *standard ounce* in London Market
	d.
1915	27¼
1916 (December)	37
1917 (August)	above 43
1917 (September)	55
Period of control by U.S.A. and British Governments. September 1917 to May 1919.	Between 47¾ and 50
May 1919 (removal of control) ...	58
17th December 1919	78

The above figures show that the rise in price was continuous, except during the period when the Governments of the United

States of America and of Great Britain instituted control over the trade in silver and over its price. In August 1917, the price exceeded 43*d*. *It is important to remember that this figure, 43d., marks the point at which the exchange value of the rupee at 1s. 4d. was equivalent to its intrinsic value ; so that any rise in price to 43d. and above it necessitated the raising of the exchange value of the rupee.* Since May 1919, the rapid rise in price of silver was due to the exceptional demands from China.

(*f*) INFLUENCE OF THE DOLLAR-STERLING EXCHANGE :—There was another factor which tended to raise the price of silver in the London Market. As America had been the principal source of the world's silver supply, the chief payments for that metal had to be made ultimately in that country. Therefore, it had to take account of the London-New York Exchange, and any rise or fall in that exchange would be reflected in the price of silver. Any fall in the sterling exchange would result in paying more sterling for a given quantity of silver than before.

Thus, if the exchange value of the rupee is 2*s*., the Secretary of State can buy silver for coinage of rupees without loss at 63*d*. per standard ounce. If now the London-New York Exchange fell, say 10 per cent., the sterling price of silver would rise to over 69*d*., as the direct result of the fall in exchange. Under these circumstances, if silver had to be bought for Indian coinage, the exchange value of the rupee would have to be raised to nearly 2*s*. 2½*d*.

CONCLUSIONS :—Hence, as the price of silver rose steadily, the *exchange value of the rupee had to be raised accordingly ;* otherwise, *the intrinsic value of the rupee would be greater than its exchange value, and as a consequence, the rupee would disappear from circulation, or would be melted down or exported.*

Besides this, the heavy *purchases of silver* (due to the heavy and continuous requirements for silver coin) and the *rising prices* at which they had to be made, rendered the pre-war currency and exchange system impracticable.

Section II—Measures taken by the Government

Various measures were taken by the Government to meet the difficulties stated above.

(*a*) CONTROL OF EXCHANGE :—The machinery for regulating exchange had to be changed by force of circumstances. The Secretary of State had to ***put a limit to the sale of the Council Drafts in London on India,*** because as the demand for them was abnormal and the Paper Currency Reserve had already fallen, their sales on an abnormal scale would endanger the convertibility of the note issue. But this limitation of the amount of Council Drafts at a time when the demand for remittance to India was exceptionally strong, led to a ***divergence*** between the market rate of exchange and the rate at which the drafts were sold.

And it was essential that the exports required for war purposes should not be impeded. It was, therefore, found necessary to introduce certain measures of control. The sale of drafts was confined to banks and firms on the " Approved List ", which included the chief Exchange Banks and a few large purchasers of drafts. And these in turn were required to do business on prescribed terms with third parties, and concentrate their resources to financing the export of commodities needed by the Allies for the war.

Thus, the pre-war system of free and unlimited remittance had to be suspended. But after the conclusion of the Armistice these restrictions were removed, and with the revival of a free market for gold, the old conditions were restored.

(*b*) RAISING THE RATE OF EXCHANGE :—As was stated, the rise in price of silver to 43*d*. per standard ounce and above it, necessitated the raising of the rate of exchange, as at 43*d*. the melting point of the rupee was reached. The following table shows the successive steps of raising the exchange :—

Date of introduction	The minimum rate for immediate telegraphic transfers	
	s.	*d.*
3rd January 1917	1	$4\frac{1}{4}$
28th August 1917...	1	5
12th April 1918	1	6
13th May 1919	1	8
12th August 1919...	1	10
15th September 1919	2	0
22nd November 1919	2	2
12th December 1919	2	4

(*c*) PURCHASE OF SILVER :—These modifications in the system would not have been effectual in meeting the situation unless special measures had also been taken to *increase the supply of currency*.

The Secretary of State had to purchase silver to meet the enormous demand for rupees, and to reduce competition in buying silver, which would otherwise have raised its price still further, the import of silver into India on private account was prohibited in September 1917. He bought nearly 32 crores of standard ounces of silver in five years.

But the world's demand was still very heavy and other sources of supply had to be tapped. The Government of the United States of America was approached with a request to release a portion of the silver dollars held in their reserve. The request met with a ready response, and in April 1918, the United States Congress passed the *Pittman Act*, which authorized the sale to other Governments of silver not exceeding 35 crores of dollars from the dollar reserve. Of this amount the Government of India acquired 20 crores of fine ounces, and this enabled them to tide over a very serious currency crisis.

(*d*) PROTECTION OF SILVER CURRENCY :—Attempts were also made to protect the currency against depletion by export or melting. Accordingly, from 29th June 1917, the use of silver or gold coin for other than currency purposes was declared illegal ; and, from 3rd September 1917, the export of silver coin or bullion from India was prohibited except under license.

(*e*) ECONOMY OF SILVER :—The use of silver was also economized by the issue of Rs. 2½ and Re. 1 notes and by the introduction of new two-anna, four-anna and eight-anna nickel coins.

(*f*) THE USE OF GOLD :—Efforts were also made to increase the stock of gold, and with this object an ordinance was issued on 29th June 1917, requiring all gold imported into India to be sold to the Government. And the gold mohur, a 15-rupee coin of the same weight and fineness as the sovereign, was minted at the Bombay Mint as an emergency coin to supplement the stock of sovereigns available for issue during the crisis of 1918.

Gold was also sold to the extent of £4,000,000, and sovereigns

and gold mohurs to the amount of £11,000,000 were issued for the financing of certain crops.

(*g*) INCREASE IN NOTE CIRCULATION :—One of the most prominent features of the currency policy of the Government before the outbreak of the war was the encouragement of the use of notes by giving ample facilities for their encashment. This policy was continued as long as the supply of rupees was adequate. But the absorption of rupees was abnormally high during the war and the silver balances had fallen very low. The unfavourable war news in March and April 1918 caused a run on the Bombay currency office and in other places. Inconvertibility appeared to be inevitable when the delivery of Pittman silver saved the situation. Facilities for the encashment of notes at district treasuries were withdrawn, and restrictions were placed on the transport of specie within the country. The result was a large substitution of notes for rupees in circulation, as shown in the following table :—

Date	Gross Note circulation in lakhs of rupees
31st March 1914 ...	66,12
30th March 1919 ...	153,46
30th November 1919 ...	179,67

The gross circulation of notes increased nearly *threefold*. But, at the same time, the difficulty of obtaining sufficient quantities of precious metals for coinage, and as a backing for the issue of additional notes, necessitated the *increase in the invested portion of the Paper Currency Reserve* which was raised from Rs. 14 crores to Rs. 120 crores by various ordinances. During certain periods there was in many parts of India a considerable *discount on notes* as high as 19 per cent., because as the rupee was comparatively scarce, it was preferred to notes. But, in the year 1919 the discount tended to disappear, when it was seen that the notes were freely accepted in payment of Government dues.

(*h*) FINANCIAL MEASURES :—Various financial measures were also taken which affected the currency situation

indirectly. Apart from measures taken to increase revenue and curtail expenditure, various *War Loans* were floated which yielded Rs. 130 crores, and short-term *Treasury Bills* were issued which brought in nearly Rs. 65 crores. These measures materially assisted towards meeting the heavy demand for remittance to India.

Such were the developments in the Indian exchange and currency system since 1914.

CHAPTER XIX

Post-War History upto 1926

- Period I the year 1919
  - Section A
    Rise in price of silver continued
  - Section B
    Report of the Babington-Smith Committee
- Period II
  - January 1920 to September 1920
    - Consequences of the ratio 2*s*. a rupee
- Period III
  - 1921 to 1925
    - Condition of exchange
- Period IV
  - 1926
    - Report of the Hilton-Young Commission

The history of Indian currency and exchange, after the war and coming down to the end of 1926, can, for the sake of clearness, be studied into four periods, as given in the above chart. Each period is so selected that it marks out the influence of an outstanding feature.

PERIOD I—The year 1919

Section A—Rise in the price of silver continued

In the last chapter we have already drawn out the important facts in the Indian currency history during 1919. We need only summarize them here.

The important features were the following :—

(1) *The Balance of Trade was still highly in favour of India* in spite of the war being over, because although the huge demand for Indian commodities for war purposes was considerably reduced, a new demand arose in Europe and America for manufacturing peace-time goods. It became increasingly difficult to liquidate this favourable balance.

(2) It was also stated how the price of silver steadily rose, till it reached 78*d*. per standard ounce on 17th December 1919, and brought with it extraordinary difficulties in the currency system, the chief being endangering the convertibility of the note issue which was only averted by the Pittman silver.

(3) The influence of the Dollar-Sterling Exchange was also made clear. As sterling fell in terms of the dollar, the price of gold rose to the same extent, and the rate of exchange fluctuated.

Section B—Report of the Babington-Smith Committee

All the difficulties consequent on the unprecedented rise in the price of silver, and specially the one of securing the convertibility of note issue, led to the appointment of a committee to consider the best means of overcoming them. Accordingly, in May 1919, the Babington-Smith Committee was appointed. The Committee consisted of eleven members of which Mr. Dadiba M. Dalal, the only Indian member, wrote a minority report, because he did not concur with the views of his colleagues on vital currency principles.

CONCLUSIONS DRAWN FROM WAR HISTORY :—The conclusions which the Committee drew from the history of the Indian currency system during the war were the following :—

(1) The system built up since 1893 worked well, and was beneficial to India.

(2) "*But the system was not proof against a great rise in the value of silver.*"

It was the inherent weakness of the system evolved after 1893 that, while it made provision against a fall in the value of the rupee below 1*s*. 4*d*., *it* made no provision against *a rise in the value of the rupee above* 1*s*. 4*d*. *consequent on a rise in the price of silver. The rupee melting-point, in short, was not considered.*

RECOMMENDATIONS OF THE MAJORITY :—

IMPORTANCE OF STABILITY OF EXCHANGE :—Before coming to the stabilization of the rupee the Majority examined in what respects exchange stability was important. "Our conclusion," they wrote, "is that, for the current operations of trade, *stability is an important facility rather than an essential condition.* There are many instances, including that of India herself before the closing of mints, which show *that trade has flourished, and can flourish, with a fluctuating exchange.* The conditions are somewhat more speculative, but the difficulties which may arise are not insuperable, and the banks are not

slow to supply machinery which enables the merchant to cover his risks."

And yet they observed that stability of the rupee was of great importance for India, and that the rupee should be stabilized at *as early a date* as possible. The reasons given were the following :—

(1) that " stability is a necessary condition for the free investment of external capital in India, as well as for the protection of capital already invested " ;

(2) that " a stable exchange facilitates the free movement of funds to and from India, thus assisting commercial finance and tending to avert temporary stringencies " ;

(3) that " whatever the evils and inconveniences of instability may be, they are increased if the movements are brought about *not by the automatic action of economic causes, but by administrative acts.*" The commercial community are prepared to deal with fluctuations of exchange resulting from economic causes ; but they feel that " if official action intervenes to interpret the play of natural forces and to give effect to them, an element of uncertainty is introduced which is beyond their reckoning." In short, an automatic system, which did not depend upon official action, was greatly to be preferred ;

(4) that " a stable level of exchange gives the most healthy condition for production and trade."

I. THE RATIO SHOULD BE 2*s*. GOLD :—The Majority recommended that the rupee should *be fixed at* 2*s*. *gold*. It is important to know the grounds on which they based their decision.

(A) THE PRICE OF SILVER :—The most important factor they considered was the price of silver. From the evidence which they collected they believed that the *price of silver would remain high for some years,* as the world's demand for silver was likely to continue on a large scale. Accordingly, they estimated that, keeping a safe margin, if the price of silver were 62.9*d*. (gold) per standard ounce (137.8 cents per fine ounce in America), then the rupee's bullion price would be equal to 1*s*. 11.36*d*. (gold). If we add to this the cost of making the rupee, the total would be 2*s*. *approximately*.

The Majority believed that, if the exchange value of the rupee were fixed at a figure not lower than this, there were reasons to believe that the rupee could be established as a token coin.

(1) EFFECT ON THE LEVEL OF PRICES IN INDIA :— They concluded that, *but for the high rate of exchange, the level of prices in India would have risen still further,* and affected the population adversely. They admitted that the exceptional conditions, under which trade was conducted during the war, made it impossible to measure precisely the extent to which the high exchange influenced rise in prices. There were, for instance, factors such as Government control over the movement and prices of foodgrains in India and restrictions on finance and freight, which also prevented prices rising.

But they stated that, in accordance with the accepted economic theory, Indian prices would, but for the rise in exchange, have been still further enhanced. This theory was explained as follows :—

(i) Taking the *case of imported commodities,* we would find that the sterling price at which the merchant could lay down goods in India would be determined by the cost of production, transport, and other charges. If the exchange value of the rupee rose, this sterling cost would be represented by a smaller number of rupees, and the goods could be sold at a lower rupee price.

(ii) Again, taking the case of exports such as wheat, (whose price outside India was determined by world-wide conditions of production and consumption), we would find that the sterling price, which could be obtained for a given quantity of it, would, if exchange rose, be represented by a smaller number of rupees, and the price which the grower would receive must necessarily be lower than before.

This would mean a heavy loss to the agriculturist. But the Majority considered that, as the world's shortage of foodstuffs and raw materials was likely to continue for some time, the demand for Indian produce would be ensured. Besides, "the general rise of prices in countries importing from India should enable the Indian producer to obtain a satisfactory rupee price for his produce in spite of the high exchange."

But these considerations would not apply to products which

were grown almost entirely for *internal consumption*, *e.g.*, food-grains, such as, jawar and bajra. Nor would they be applicable in the case of jute, which enjoyed a practical monopoly. "It was not, therefore, desirable to restore a low level of exchange, for it would tend to augment prices generally and to aggravate the danger of social and economic discontent."

(2) EFFECT ON INDIAN TRADE :—A high exchange stimulates imports and checks exports, but they stated that these effects were transitory, and that they were no longer operative when wages and other elements of cost had adjusted themselves to the new level of exchange.

Besides, Indian trade was prosperous and was likely to maintain this prosperity for some years. The world shortage of raw materials and foodstuffs was likely to ensure a continued demand for Indian produce during the period necessary for complete adjustment, and this was likely to give him a satisfactory rupee price, because of the rise in general prices in countries importing from India.

Moreover, high exchange would bring to the producer various advantages. It would tend to keep down the cost of imported stores and machinery as measured in rupees ; and if it would exercise a check on the rise of prices, it would reduce the cost of living in India and consequently put a check on the rise of wages.

Thus, they concluded that Indian trade was not likely to suffer any permanent injury from the fixing of exchange at a high level.

But the Majority gave *one qualification* to this statement. *It was that prices should remain at a high level for a considerable time*, and that any return to lower level would be gradual. But if, on the contrary, a rapid fall in world prices were to take place, the cost of production in India would fail to adjust itself, with equal rapidity, to the lower level of prices, Indian exports would suffer, and the rate of exchange could not be maintained.

(3) EFFECT ON INDIAN INDUSTRIAL DEVELOPMENT :—A high rate of exchange would temporarily stimulate competitive imports into India, especially from countries where the cost of production was low. But even during the period which may elapse before the adjustment of prices and other

conditions to the new level was complete, they considered that India was not likely to be adversely affected because the cost of production in the exporting countries of Europe and America had greatly increased. Moreover, a high exchange would tend to bring to India the advantage of a low cost for wages and raw materials and for imported articles that enter into cost. Therefore, the development of Indian industry would not be seriously hampered by a high rate of exchange.

(4) EFFECT ON HOME CHARGES :—They also pointed out an incidental advantage in fixing the exchange at a high level. At 1*s*. 4*d*. exchange to remit £25,000,000 a year, the rupee cost would be 37½ crores ; but, if the same were to be remitted at 2*s*. exchange, the rupee cost would be 25 crores, *i.e.*, a saving of Rs. 12½ crores.

On the other hand, there would be a loss involved in the revaluation in rupees of the sterling investment and the gold with the Secretary of State. This loss would amount to Rs. 38.4 crores.

But, if the whole of the amount saved in respect of remitting the Home Charges were utilised for the purpose of meeting this loss, it could be recouped in three years. And thereafter it would enable the Indian Treasury to do without additional taxation of Rs. 12½ crores every year.

II. THE RUPEE SHOULD BE LINKED TO GOLD AND NOT TO STERLING :—The second main recommendation of the Majority was with regard to the manner in which the exchange should be fixed. Should it be linked to sterling (its pre-war relation) or to gold ? They recommended that the rupee should be linked to gold and not to sterling.

THE REASONS GIVEN :—(1) Before the war the convertibility of sterling (paper) into gold in England was complete. Gold coins were in circulation and sterling and Bank notes could be exchanged without difficulty with gold. It was, therefore, unnecessary, in considering the problems of Indian exchange, to make any distinction between the two. But since the war the situation had been different. The gold coin was no longer in circulation and had appreciated in terms of sterling. The sovereign (gold) was at a premium of 28 per cent. and £1 sterling (paper) was at a discount of 22 per cent. on 17th December 1919. Under

these circumstances, and specially because sterling was depreciating, it would be unwise to fix the rupee in relation to sterling. Until sterling became again equivalent to gold, *the rupee-sterling exchange would fluctuate, in the same manner as the dollar-sterling exchange*, and far from making the rupee stable, it would make it fluctuating.

(2) If the rupee were linked to sterling, the exchange value of the rupee to be fixed in sterling would have to be a *higher one* than in gold, because sterling had depreciated very much. This might not be regarded as an immediate disadvantage. But in the future, if sterling were to recover its value and become again equivalent to gold, the sterling value for the rupee might *be found to be* high (since the value would have increased in relation to gold). And if it were to be reduced, the *reduction would be too heavy* and would be injurious to commerce and trade. If, on the other hand, the value were fixed in relation to gold, it could be fixed safely at a lower figure.

(3) If the relation of rupee to sterling were fixed, while sterling varied in relation to gold, the rupee would vary with gold. But if the rupee and the sovereign were both to remain unlimited legal tender in India, as it was thought essential, it was necessary that *their relation should be fixed*, because two coins cannot remain in circulation as unlimited legal tender and at the same time stand in a variable relation to one another.

(4) The Majority also considered it very desirable to permit the free export and import of gold bullion and coin and to issue gold coin in India for an equal weight of gold bullion subject to an appropriate coinage charge. This could be facilitated by linking the rupee to gold.

SUMMARY OF RECOMMENDATIONS :—We now summarize the main conclusions and recommendations of the Majority :—

(1) It was desirable to *restore stability to the rupee* and to *re-establish the automatic working of the Indian currency system* (The Gold Exchange Standard).

(2) The exchange value of the rupee should be fixed in terms of *gold* rather than in sterling.

(3) The stable relation to be established between the rupee and gold should be at *the rate of Rs. 10 to one sovereign*, or, in other words, at the rate of one rupee for

11.30016 grains of fine gold, both for foreign exchange and for internal circulation.

(4) The obligation of the Government to give rupees for sovereigns should be withdrawn.

(5) The import and export of gold to and from India should be free from Government control.

(6) The prohibition on the import of silver should be removed, but that on the export of silver should be retained for the present with a view to protecting silver from depletion by export.

Other important recommendations were with regard to the constitution of the Gold Standard Reserve and the Paper Currency Reserve and the sale of the Council Bills and Reverse Councils.

(*a*) As regards the *Gold Standard Reserve* :—

(1) that no limit can yet be fixed to its amount ;

(2) that it should contain a considerable proportion of gold ;

(3) that the remainder should be kept in securities issued by Governments within the British Empire (other than the Government of India) and having a fixed date of maturity of not more than 12 months ;

(4) that a proportion of gold, not exceeding one half, should be held in India.

(*b*) As regards *Council Bills* and *Reverse Councils* :—

(1) that Council Drafts, although sold for providing for Home Charges could also be sold by the Secretary of State in excess of his immediate requirements, ***when a trade demand for them exists,*** by competitive tender ;

(2) that during the periods of exchange weakness the Government of India should be authorized to announce, without previous reference to the Secretary of State, their readiness to sell weekly a stated amount of Reverse Councils.

(*c*) As regards *Paper Currency Reserve* :—

(1) that in order to give greater elasticity to note issue, the Proportional Reserve System may be introduced ;

(2) that the fiduciary portion should not exceed 60 per cent. of the gross circulation.

CONCLUSIONS OF THE MINORITY (Mr. Dadiba Merwanji Dalal) :—Mr. Dalal entirely dissociated himself from the recommendations of his colleagues. He, in his Minority report, answered in details the various arguments of his colleagues. We shall summarize here those of his views which have an important bearing on the future history of Indian currency.

(A) SOVEREIGN—THE MONEY STANDARD :—He took the view that the legally established money standard was the *sovereign with rupees definitely related to the sovereign at the rate of* 15 : 1. "In contradistinction to this legally established standard," he stated, "the Gold Exchange Standard has no legal validity. It has not been clearly and explicitly defined. The authorities who conduct it *exercise the widest discretion* in its regulation, but hitherto have been careful to respect the legally constituted ratio between the rupee and the sovereign. The policy pursued is one which has persistently ignored the essential safeguards of a gold standard, and *particularly the safeguard, of limiting the issue of token coins.* The *endless issue of token coins, much in excess of what is needed for internal exchange purposes,* amounts to a form of taxation on the money of the public. It is this circumstance that is to a large extent responsible for the extraordinary demands for gold and sovereigns in India. It virtually compels the Indian people to seek full value for the token money, with which they have been over-supplied for ordinary currency purposes, and is thus largely responsible for the hoarding of gold of which so much is heard. . . . It has by mere executive action changed the legally established gold standard into Gold Exchange Standard making the maintenance of exchange the object to be attained in place of the provision of gold money with a limited token money."

Moreover, the system broke down at a time when India enjoyed a large measure of prosperity.

(B) RISE IN PRICE OF SILVER WAS ENTIRELY ARTIFICIAL :—He was unable to fall in with the idea that the rise in price of silver afforded solid grounds for raising the rate of exchange. "I contend that the price of silver has been artificially forced to its high level." The reasons given were the following :—

(*a*) *The rise in price of silver could have been prevented by*

removing the embargo on exports of silver from India after the war ended, and it was after the war that the great rise took place. India could easily have spared silver for export; such exports would have been profitable to her, and they would have prevented the great rise in price. The price 78*d*. per standard ounce was made possible only by the prohibition of exports of silver from India and by the raising of the rate of exchange, which had the effect of lowering the rupee value of all silver held there and making exports unprofitable.

It was because India was made a potential buyer instead of a seller that the silver markets were inflamed and the price was raised.

(*b*) Coupled with this embargo on exports of silver from India was another fact. The Pittman Act compelled the Government of the United States to replace all the silver dollars which she had given to other countries, and until that was done, to go on buying American silver at 1 dollar per fine ounce. As this process of replacement was likely to continue for some years (as the silver dollars withdrawn under the Act represented between twice and three times the normal American production), the production of American silver was assured of a market. Under the circumstances any probability of fresh demands for silver from India and China was expected to raise the price of silver. Had India been allowed to sell silver, its rise in price would have been prevented. In short, the high price of silver was to be regarded as entirely artificial.

(*c*) THE STANDARD RATIO 1*s*. 4*d*. A RUPEE SHOULD NOT BE ALTERED :—He was of opinion that there was no justification whatsoever for raising the ratio because—

(*a*) the high world price of silver was wholly artificial and thoroughly inflated and could have been prevented by removing the embargo on the export of silver from India.

Even if the embargo were not removed, there was no occasion to raise the ratio. India did not require additional supplies of rupees. She could carry on for many years without any new silver coinage.

(i) The only alteration required would have been to *stop the coinage of rupees, and that would have occurred automatically by reason of the loss coinage would involve.*

(ii) At the same time, ***the sale of rupee bills in London by Government in excess of their own Treasury requirements should have been stopped,*** and the balance of trade left to be adjusted by other means than silver. Rather than give up the sale of rupee bills (and thus remove the necessity of further silver coinage in India), the Government unnecessarily raised the rate of exchange.

(*b*) There was no advantage in making the rate of exchange follow the price of silver. One of the advantages claimed in former years for issuing rupees instead of sovereigns was that it was economical. The rise in price of silver took away the advantage. "If silver has to be bought at present prices (78*d*.) and coined into rupees at the present rate of exchange, there is no economy of any consequence in using silver instead of gold."

The world-wide embargo on the exports of gold was removed and the United States of America became a free market for gold on 9th June 1919, and the gold production of South Africa became available in London on 18th July 1919; there was, therefore, absolutely no justification for raising the rate of exchange.

(*c*) "Raising the rate would have disastrous consequences to India and to the people of India. They must seriously disturb the existing relation between creditor and debtor. They will cause dislocation and set-back to several Indian industries and vast continuous losses on the exporters of Indian produce. There is a danger of India's balance of trade turning against her and so checking her prosperity. And it should be remembered that between 100 and 200 millions of people live on the brink of starvation, and a great permanent change in the rate of exchange must ultimately bring intense distress to millions of the helpless masses." It would also cause a colossal loss to the Indian public who held about 50,000,000 sovereigns, and enormous loss to India by the revaluation of the sterling securities and gold held in the reserves.

PERIOD II—The year 1920

Consequences of the 2s. rupee ratio

1920

up to June	from June to September	from September to December
Effects of the fall in London-New York Exchange	**Effects of adverse balance of trade**	**Effects of withdrawal of support to exchange**

The recommendations of the Babington-Smith Committee were accepted by the Secretary of State, and various notifications were issued on 2nd February 1920 along with the publication of the report.

THE ACTION TAKEN ON THE REPORT :—The notifications were as follows :—

(1) The acquisition rate for gold imported under license into India would be fixed at Rs. 10 per sovereign or one rupee for 11.30016 grains of fine gold ;

(2) Council Drafts and Telegraphic Transfers would be offered for sale weekly by competitive tenders with no fixed minimum rate ; and that Telegraphic Transfers would be offered in India when required at a rate based on the sterling equivalent of the price of 11.30016 grains of fine gold as measured by the prevailing sterling-dollar exchange, minus a reduction for the cost of remitting gold ;

(3) the obligation on the part of the Government to give rupees in exchange for sovereign and half-sovereign at the rate of Rs. 10 and Rs. 5 respectively was cancelled ;

(4) prohibition on the import of silver and the duty on its imports were abolished ;

(5) the prohibition of melting of gold and silver coins was removed.

INFLUENCE OF THE DOLLAR — STERLING EXCHANGE :—During the war, as we have seen, the British Government, in order to control the price of silver, had "pegged" the dollar-sterling exchange at $4.76\frac{7}{16}$ dollars equal to £1 sterling. The control on the exchange was removed in March 1919, and the free market for gold was established.

The notification that bills would be sold in India subject to *the price of gold being regulated by the sterling-dollar exchange* had a great influence on Indian exchange at this time. It may at first be asked, why was this complication introduced ? It was because the United States of America was the country which was the real source of world's supply for gold and silver. Besides, its standard coin was at *par* with gold, being a creditor country to England and other countries, and it had a free market for gold. As England had to make payments of enormous sums to the United States of America for the loans borrowed, the *price of gold in London had to take account of the sterling-dollar exchange.* If sterling fell in relation to the dollar owing to adverse circumstances, more sterling would have to be paid for buying a given quantity of gold in America than before. The sterling price of gold in London would, therefore, rise and the gold sovereign would fetch more shillings than before. Therefore, if one sovereign is equal to Rs. 10, each rupee would buy more shillings than before, *i.e.*, the rupee-sterling exchange would rise accordingly. *If the sterling-dollar exchange fell, the rupee-sterling exchange would rise.*

THE SALE OF REVERSE COUNCILS :—Even when the notification was issued with regard to the two-shilling ratio, the market price of silver was higher than 2 shilling gold. This was an opportunity for a financier to wait but India Office would not do so. The Government announced its intention to maintain the rate by the sale of Reverse Councils in India at the market rate. This announcement resulted in an unprecedented demand for them.

(i) EXPORTERS DISCOUNT THE BILLS :—On 2nd February the American cross-rate fell to 3.65, and the rupee-sterling exchange rose accordingly. But the Indian exporters, fearing that further fall in cross-rate would occur, thought it wise to sell off their bills to prevent further loss to themselves. So heavy was the demand for discounting the Bills that the exchange rose to 2*s*. 8½*d*. within three days of the announcement of the 2*s*. ratio, and at one time it soared as high as 2*s*. 11*d*. But within a few days a further fall took place in the sterling-dollar exchange, and under the same influence the exchange jumped up to 2*s*. 10½d. *on February* 11. But after this date the tide of the exporters anxious to sell the bills ebbed.

(ii) RUSH FOR REMITTANCES TO ENGLAND :—The Babington-Smith Committee had made the recommendation that Council Bills and Reverse Councils may be sold to the public when "a trade demand for them" existed. As the rate of exchange steadily rose, there arose a keen demand for remittances to England, as it was very cheap to do so. The demand came from genuine Indian importers for Reverse Councils. Foreign businessmen and firms in India found this the most profitable time for remitting their profits to England. The huge war profits also led to a boom in the formation of Joint Stock Companies. And those companies, which had placed orders in England for machinery, now remitted in advance the payment for them. Lastly, there were those speculators who remitted their money to England in the hope of bringing it back after exchange fell sufficiently thereby making large profits.

So great was the demand for Reverse Councils and such was the speculation indulged in them, that there arose *a difference between the Reverse Council rate and the market rate and the money market was completely disorganized.* The market rate began to fall, but the Reverse Council rate remained high for some time, and this in return led to a gigantic speculation.

(iii) ADVERSE BALANCE OF TRADE, JUNE 1920 :—But the most important cause, which aggravated the demand for the Reverse Councils and kept the market rate of exchange lower than the rate for them, was the adverse balance of trade. From January to June 1920 the favourable trade balance was diminishing little by little. The value of the imports was increasing considerably, whereas the value of the exports was diminishing. And in June the balance of trade became definitely *unfavourable* to India, and there was an excess of imports over exports to the extent of Rs. 2.83 lakhs.

The reasons for this were not far to seek. The Indian export trade was already weak. The great consuming markets were already glutted with Indian produce, nor had some European countries the buying power to purchase our commodities sufficiently. The rains of 1920 had failed and the embargo on foodstuffs could not be removed. Besides, the high exchange gave a powerful stimulus to import trade ; and immense quantities of manufactured goods, specially textiles, began to come forward. At this time Japan was the largest buyer of Indian cotton, but

a commercial crisis in that country not merely stopped Japanese merchants from buying it, but they resold cotton in the Indian market.

This adverse balance continued throughout the rest of the year and made the stabilization of the exchange at 2*s.* gold an impossible problem.

The result of the adverse balance of trade was a ***heavy fall in exchange.*** On 1st June it stood at 2*s.* 1¼*d.*, and it began to fall until it reached 1*s.* 8¼*d.* by the end of the month; then there was some recovery after which it fluctuated round 1*s.* 10*d.* up to September.

ALL ATTEMPTS TO RAISE EXCHANGE FAIL :—Strenuous efforts were made by the Government to strengthen and to prevent the exchange from falling.

(1) They sold £2 millions of Reverse Councils a week, then £5 millions, and ultimately dropped down to a steady £1 million.* The lowest tender offered was of Rs. 50 lakhs, but this aggravated the evil, and "exchange became a tool of wealthy speculators and exchange banks". And the wider became the margin of difference between the market rate of exchange and the Reverse Council rate, the more intense became the speculation.

(2) Being unsuccessful in holding the rate at 2*s.* gold (on the basis of the sterling-dollar exchange) the Government tried to maintain it at 2*s.* *sterling,* leaving the gap between sterling and gold to be closed when the dollar-sterling became par. Immediate Telegraphic Transfers were sold from this date at 1*s.* 11$\frac{19}{32}$*d.*—this figure represented the rate which would ultimately hold when sterling once more returned to parity with gold.

This attempt also failed, because the natural forces of trade were too strong for any artificial action.

(3) In order also to maintain the exchange at 2*s.* gold, the Government continued to sell considerable quantities of gold in India every fortnight. They sold 53 millions of gold, but this did not affect the premium on gold. The object was to reduce the price of gold relatively to the rupee. But attempts to do so failed, and gold at certain times actually left India for liquidating the adverse balance.

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* *The Indian Year Book,* **1922.**

(4) The Government of India at this period tried their utmost to *contract currency* with a view to bringing up the exchange value of the rupee. When the Reverse Councils were bought by the public, they were paid for in currency notes and silver rupees. *These currency notes were withdrawn from circulation and cancelled.* The sales of the Reverse Councils were met by the sale of the securities in the Paper Currency Reserve, because the Treasury Balance held by the Secretary of State proved insufficient for this purpose. Hence to the extent that the currency notes were cancelled, *the Paper Currency Reserve was reduced.* Thus, the gross circulation which stood over 183 crores by the middle of January 1920, was steadily withdrawn till it was reduced to 158 crores by the middle of September.

WITHDRAWAL OF SUPPORT, SEPTEMBER 1920 :—All attempts having failed to strengthen the exchange, the Government suspended entirely the sales of the Reverse Councils at the end of September. All support was withdrawn, therefore, from exchange which was left to the tender mercies of supply and demand. As soon as the Government withdrew their support, the exchange at once fell from 1*s*. 10*d*. to 1*s*. 8*d*., and then continued to fall till it reached nearly 1*s*. 5*d*. in December.

THE SACRIFICE INVOLVED :—The measures taken to bring up the exchange to 2*s*. had disastrous effects on the Indian Exchequer and on Indian trade.

(*a*) In the first place, the Reverse Councils were paid in London out of the sterling securities and Treasury Bills belonging to the Paper Currency Reserve. These securities and bills were bought at the rate of Rs. 15 = £1. But they were sold to pay for the Reverse Bills at the rate of £1 = Rs. 10 and sometimes Rs. 8 and even Rs. 7.

The difference was the heavy loss borne by the Indian Treasury. The total amount of the Reverse Bills sold was £55,382,000. This meant a loss of more than Rs. 40 crores to the Indian Exchequer, and that too at a time of adverse trade balance.

(*b*) The effects on Indian business were acute. " Exporters found themselves loaded with produce for which there was no foreign demand ; importers found themselves loaded with imported goods, bought in the expectation of the continuance of a high rate of exchange, delivered when it had fallen one and

four pence from the highest point reached. Immense losses were incurred by importers, who, when the year closed, were struggling to liquidate their stocks in almost desperate conditions."*

(*c*) Besides, deflation of currency brought the importers into serious difficulties. In the first place, it made the money market tight and raised the bank rate of interest on loanable money ; and in the second place, it tended to bring down the general level of prices. In both ways, therefore, businessmen were hard hit, and were compelled to sell off their stocks at ruinous prices. Thus, in the words of Sir Stanley Reed, " a policy which was avowedly adopted to secure fixity of exchange produced the greatest fluctuations in the exchanges of a solvent country and widespread disturbance of trade, heavy losses to the Government, and brought hundreds of big traders to the verge of bankruptcy."

PERIOD III—1921-1925

TRADE CONDITION DURING THE YEARS :—During the year 1921-22, the serious depression in trade continued. " The year 1921-22 will rank as a classical example of what trade-cycle economists characterise as the readjustment period."† The period of readjustment, after the boom that followed the war, began with 1921, when the period of liquidation set in. Europe was still unable to buy Indian commodities in sufficient quantities and the balance of trade was *against* India. The chief factors responsible for this were the falling tendency of prices and the instability of exchange.

But in 1922 the stagnation in exports disappeared and the balance of trade became favourable to India. The rains were ample and good harvests were reaped in almost all parts of the country and the exportable surpluses of foodstuffs and raw materials were considerable. But the real factor which changed the tide was the purchasing power of European countries, which increased after the notable improvements in various industries. This prosperity in India was reflected in the import of treasures to the extent of Rs. 59 crores as against Rs. 13 crores, which was the total amount of the two preceding years.

The improvement in India's trade and commerce was main-

* *The Indian Year Book*, 1922.
† *Ibid.* 1923.

tained during the following years, and there was steady progress towards more stable economic conditions. This improvement was as follows :—

Year	Exports and Imports of Merchandise on private account (in *crores* of rupees)			Total Net Imports of treasure on private account (in *crores* of rupees)
	Exports	Imports	Net exports	
1920	258	335	–77	1
1921	245	266	–21	12
1922	314	224	90	59
1923	362	217	145	47
1924	398	243	155	94
1925	375	226	149	62

EXCHANGE DURING THE PERIOD :—It was stated how, on the 28th September 1920, the Government abandoned the attempt to maintain the exchange at 2*s*. sterling. Left alone, the rupee began to find its own natural level, subject to the laws of demand and supply (see table at the end of the Period). The price of silver was at this time *falling rapidly*. And under the combined influence of adverse balance of trade and fall in price of silver, the exchange fell steadily until in December 1921, it reached 1*s*. $3\frac{7}{8}$*d*. sterling or 1*s*. $1\frac{5}{32}$*d*. gold. The Government of India were unable to contract currency sufficiently to bring up the exchange.

ATTEMPTS TO BRING EXCHANGE UP TO 1*s*. 4*d*. STERLING :—But during 1922 the balance of trade was favourable to India and the Government took various measures within their power to prevent the rupee from falling below 1*s*. 4*d*. sterling.

(1) In the first place, increase in taxation and retrenchment were resorted to in order to balance the Budget.

(2) At the same time the Secretary of State stopped the sale of Council Drafts in London, and thereby prevented the additions

of rupees which would have been made to the circulation in India. He met his requirements by borrowings in London and by receiving from the Imperial Government some part of the amount which it owed to the Government of India for expenditure incurred by the latter on its behalf.

(3) Then, the currency was also deflated throughout the year.* The methods employed were the *sale of Indian Securities in the Reserve and the corresponding cancellation of notes that came in, and applying* the interest on securities in the reserve to the deflation of note issue.

RUPEE REACHES 1*s*. 4*d*. STERLING (JANUARY 1923) : By the combined effect of these measures the rupee reached 1*s*. 4*d*. sterling in January 1923, its pre-war level. And, since the balance of trade was also favourable to India, there was a demand from some quarters that the fictitious ratio of two-shillings may be abolished and the pre-war ratio of 1*s*. 4*d*. sterling established. But the Government considered such a step hazardous, as it was not possible to forecast accurately the future of sterling.†

DEFLATION OF CURRENCY AND STRINGENCY IN MONEY MARKET :—During the year 1923, stringency of money was generally felt in the Indian money market and the Government had to take power to issue *emergency currency* to the extent of Rs. 12 crores *against commercial bills* endorsed by the Imperial Bank. Besides, they had to purchase sterling in *India* and issue fresh currency against it. "To do something to mitigate stringency in the money market, we have remitted no less than 12 crores (sterling) to London against issues of Paper Currency in India."‡ Thus, in all Rs. 24 crores of emergency paper

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* It would interest the reader to know the various ways of deflating or contracting currency given by Professor H. S. Jevons in his book *The Future of Exchange and Indian Currency* (pages 190-193). He gives three principal ways of contraction: (1) By the sale of Reverse Councils and cancellation of currency notes equivalent to the price paid for them. (2) By realization of the metallic portion of the reserve. The operation is this. A particular number of silver coins should be melted down or sold and the loss arising to be made up from the sale of gold in the Paper Currency Reserve which would bring a profit. (3) By the sale of rupee securities in the reserve and notes to be cancelled off to the value of the price realized by the sale of the securities. Or a loan may be issued and the proceeds may be used for the redemption of the rupee securities and cancellation of notes.

Each of these methods was pursued by the Government of India as occasion required.

† "You know very well the difficulties which England is facing at the present moment. On the one hand, the payment of the American debt involves a direct burden on the exchange, of which the full effects have yet, perhaps, to be appreciated on both sides of the Atlantic. On the other hand, internal resources are being strained by yet another winter of unemployment." Sir Basil Blackett, in his speech before the Associated Chambers of Commerce on 5th December 1923.

‡ Budget speech of the Finance Member on 29th February 1924.

currency was issued. But even these measures were not adequate enough to satisfy the needs of trade. This was proved by the fact that the rate of the Imperial Bank of India stood at 9 per cent. from February to April 1924.

All these factors would lead one to conclude that the *expansion of currency* to meet trade requirements was inadequate. In other words, there *was relative contraction of currency or deflation* of currency. Thus, suppose at a given time trade requires an addition of Rs. 30 crores to circulation, but Rs. 24 crores only are issued, there would be a deflation to the amount of Rs. 6 crores or a relative contraction to that extent. Avoiding the necessary expansion of currency is equivalent to a contraction of currency in its effects.*

RUPEE REACHES 1*s*. 4*d*. GOLD (OR 1*s*. 6*d*. STERLING) IN OCTOBER 1924 :—The rupee rose to 1*s*. 6*d*. sterling or 1*s*. 4*d*. gold in October 1924. The action taken by the Government of India since this date was *directed towards preventing the rise of the rupee above* 1*s*. 6*d*. sterling. The reason for taking action at this point has been given by the Hon. Mr. McWatters, Finance Secretary to the Government of India :—" The position then arose that Government had before them a strong representation from the Bengal Chamber of Commerce which pointed out that the commercial community were much exercised as to the possible results of the *next busy season*. They saw *no chance of avoiding extreme fluctuations in exchange* unless some definite action was taken by Government, and the Government at that time came to the view that any substantial rise in exchange above 1*s*. 6*d*.—with possible fluctuations up and down—might be extremely harmful."†

STERLING REACHES GOLD PARITY, APRIL 1925 :—In April 1925, sterling reached gold parity, *i.e.*, 1*s*. 6*d*. sterling became equivalent to 1*s*. 6*d*. gold. And the policy of the Government since that date may be translated into *preventing the rise of the rupee above* 1*s*. 6*d*. *gold*. Since this date, the exchange value above the rupee remained practically steady at this figure

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to encourage the natural tendency to a rise by effecting some actual [illegible] currency which had been very considerably redundant after the war. After August 1923, it was to check the tendency to further rise by making some additions to the currency."

† In his answer to Q. 698 before the Royal Commission on Indian Currency and Finance, 1926.

(see table on page 291). Whether the exchange was kept at 1*s*. 6*d*., during the coming year, by being prevented from falling below that figure by Government action, or natural forces kept it at that point, we shall see in the Report of the Royal Commission on Currency and Finance, 1926. In short, we shall know whether it was a '*de facto*' ratio or a '*fait accompli*'.

RATE OF EXCHANGE FROM CALCUTTA ON LONDON ON THE 1ST OF THE MONTH

YEAR	STERLING		GOLD		
	s.	d.	s.	d.	
1920—					
January ...	2	$3\frac{7}{8}$	1	10	
December ...	1	$6\frac{3}{8}$	1	$1\frac{3}{16}$	
1921—					
January ...	1	$5\frac{1}{4}$	1	$0\frac{15}{32}$	
July	1	$3\frac{5}{8}$	0	$11\frac{23}{32}$	
December ...	1	$3\frac{7}{8}$	1	$1\frac{5}{32}$	
1922—					
January ...	1	$3\frac{15}{16}$	1	$1\frac{25}{32}$	
December ...	1	$3\frac{31}{32}$	1	$2\frac{27}{32}$	
1923—					
January ...	1	$4\frac{1}{32}$	1	$3\frac{9}{32}$	*Rupee reaches pre-war level.*
December ...	1	$5\frac{7}{32}$	1	$3\frac{3}{8}$	
1924—					
January ...	1	$5\frac{3}{32}$	1	$3\frac{1}{16}$	
October ...	1	$5\frac{23}{32}$	1	$4\frac{1}{4}$	*Rupee reaches 1s. 4d. gold.*
December ...	1	$6\frac{1}{32}$	1	$5\frac{3}{16}$	
1925—					
January ...	1	$6\frac{1}{16}$	1	$5\frac{21}{32}$	
April... ...	1	$5\frac{27}{32}$	1	$5\frac{17}{32}$	*Sterling reaches gold parity.*
December ...	1	$6\frac{5}{32}$	Nearly the same.		
1926—					
January ...	1	$6\frac{5}{32}$	Do.		
April... ...	1	$5\frac{7}{8}$	Do.		
December ...	1	$5\frac{3}{4}$	Do.		

PERIOD IV—Report of The Hilton-Young Commission, 1926

A Royal Commission on Indian Currency and Finance was appointed under the chairmanship of Commander Edward Hilton-Young. Of the eleven members of the Commission, *Sir Purushotamdas Thakurdas*, a distinguished Bombay merchant and financier, wrote a minute of dissent.

TERMS OF REFERENCE :—The terms of reference to the Commission were—

(*a*) to examine and report on the Indian exchange and currency system and practice already existing ; and
(*b*) to consider whether any modifications were desirable in the interests of India ; and
(*c*) to make recommendations.

(A) THE WEAKNESSES OF THE EXISTING SYSTEM :— They analysed the existing state of affairs both in its economic aspect, which was that of the standard of currency, and in its administrative aspect, which was that of the authority to control the currency.

(1) NO AUTOMATIC WORKING OF THE STANDARD :— *The first great weakness they pointed out was that " the automatic working of the exchange standard is not adequately provided for in India and never has been so."*

They gave the following reasons for this :—

(*a*) that there was no *statutory obligation* to preserve the stability of the gold value of the rupee. This stability was at present based on nothing substantial than the policy of the Government, and that policy could be found defined in no notification or undertaking by the Government. It had to be *implied* from the acts regarding currency, but these were subject to no statutory regulation or control. They bought and sold sterling whenever they liked ;

(*b*) that the two *reserves*, which were kept to maintain the value of token currency, were the real pivots of our currency system. (The Paper Currency and the Gold Standard Reserves.) These reserves were subject to permanent constitutions. Thus, the permanent constitution of the Paper Currency Reserve provided for a metallic holding of gold and silver of not less than 50 per

cent. of the notes issued, but these permanent provisions *had not been operative*, and during that time, the reserve was *governed by transitory provisions* which were likely to *disturb the proportion between the Paper Currency issued and the reserve kept to back it* ;

(*c*) *that the interest on investments* in the two reserves had been up to then *credited to the Government* revenue, particularly after April 1923, and not for strengthening the reserves as the Acts required.

As regards the objects and functions of the reserves, they pointed out the following mistakes :—

(*d*) that *the objects of the two reserves were not clearly demarcated* and therefore confusion arose when the reserves performed their functions ;

(*e*) that the maintenance of the convertibility of the note into silver rupee of the present fineness was only possible so long as the price of silver remained at such a figure that the bullion value of the rupee was not higher than its exchange value ; but the system *would be upset if the price of silver were to rise above 48d. per standard ounce* (when the exchange is 1*s*. 6*d*. per rupee) ;

(*f*) that the *principles governing the efficiency of the reserves were not clearly recognized.* Their efficiency for the stabilization of the external value of the rupee depended upon :

(i) their maintenance at an adequate size,
(ii) their use in an effective manner.

In principle they should have been big enough to allow the Indian Government to sell sterling to any amount required in return for notes and rupees, and they must be used promptly and without conditions and the sales must be accompanied by an equivalent contraction of domestic currency. But they stated that "in the Indian system *these principles have not at all times been clearly recognized and they are not now and never have been adequately supported and enforced by statutory provisions.*"

There was, for instance, *no provision* as to any *organic relation between the total value of token currency and the amount of the Reserves.* So far as the note issue was concerned, the statutes provided for no minimum percentage of gold or sterling securities being held in the reserve as cover against notes.

The amount of the Gold Standard Reserve and the time and manner of its use were wholly within the discretion of the Government. This they pointed out to be the *greatest weakness* in the working of the Gold Exchange Standard.

(*g*) The fundamental basis of an automatic standard was provision for expansion and contraction of the volume of currency. As the reserve rises or falls with a favourable or unfavourable trade balance, the currency must be automatically expanded or contracted, and adjustment between internal and world prices maintained. But under the Indian system *contraction of currency was not and never had been automatic.*

(2) SYSTEM WAS NOT ELASTIC :—*We now take up the second weakness of the standard which they pointed out.*

In India, there is a seasonal variation due to the requirements for financing the movement of crops. In order to provide for them, the currency authority was allowed by law to issue currency notes up to a maximum limit of Rs. 12 crores against *hundis*. This meant that there ought to be a *plentiful supply of genuine hundis*. But in practice it was found difficult to secure an adequate number of them. And this difficulty was due to various factors, *e.g.*, our internal trade was financed by a system of cash credits, so that on occasions the currency authority had been forced to use other means to give elasticity.

Besides, in case of a great financial crisis, when the need for additional cash for the support of credit was urgent, this system failed to provide for the emergency. The system was, in short, not elastic.

(3) DIVIDED CONTROL :—The third defect of the present system pointed out was that India was the only country in which the Government exercised direct control over the currency in general and over the note issue in particular. *Thus the banking and currency reserves were separated.* This diminished their capacity to effect their specific purpose of stabilization in the most economical and efficient manner.

Moreover, Government control of currency reserves resulted in a dual control of the monetary policy. "The Government controls the currency, but the Imperial Bank controls the credit. This results in *divided control*, which is likely to result in divided counsels, and failure to co-ordinate. The best course should be

to concentrate the control in one hand."

CONCLUSIONS :—Owing to these defects the *system had not the confidence of the public because of its imperfections.*

" The evolution of Indian economic system has now reached the stage when her currency can and should be placed upon a more *simple*, *certain* and *stable* basis."

(B) ALTERNATIVE PROPOSALS FOR REFORM :—The Commission considered the following possible *methods* of remedying the defects :—

(i) *The perfection of the Sterling Exchange Standard.*
(ii) The adoption of the *Gold Exchange Standard.*
(iii) The adoption of the *Gold Standard with Gold Currency.*
(iv) The adoption of the *Gold Standard without Gold Currency.*

(I) THE PERFECTION OF THE STERLING EXCHANGE STANDARD :—They stated that the main defects of this standard *could be remedied by the following provisions* :—

(*a*) " by a single currency reserve under the control of one authority, instead of two separate reserves, as at present" ;
(*b*) " by selling rupees for sterling without limit at the upper gold-point of a fixed parity, and by selling sterling for rupees at the lower gold-point of the same fixed parity."

" By so doing the system would become elastic and efficient."

ITS INHERENT DEFECTS :—But in their opinion, in spite of this, the *inherent defects of the system could not be remedied.* They were the following :—

(1) *If silver rose in price above the melting point of the rupee, the silver currency would be threatened* ;
(2) if sterling were to be divorced from gold, the rupee would also be divorced from gold ;
(3) if sterling depreciated, Indian prices would have to follow sterling prices, and the authorities would be compelled to raise the rate of exchange.

CONCLUSIONS :—" There is undoubted disadvantage for India in dependence upon the currency of a country, however stable and firmly linked to gold." India had experience of both these alternatives and the evils resulting from them were fresh in her memory.

(II) THE ADOPTION OF THE GOLD EXCHANGE STANDARD :—They suggested that this standard could* be secured by providing that the currency authorities should be compelled by law to buy and sell at the upper and lower gold-points respectively and to unlimited amounts, the *currencies of any of the principal foreign countries with a gold standard.* By doing so the rupee would be stabilized in gold.

But they emphasized that there were serious defects in the system which would still persist.

OBJECTIONS AGAINST IT :—*The inherent defects, they stated, were* :—

(1) that, if silver rose in price above the melting point of the coin, the rupee would vanish ;

(2) that *it had not the simplicity* which was essential to secure the confidence of the public. The mechanism of an exchange standard was refined. It required some knowledge of economics to understand it, and to the majority in India it was unintelligible. It was, therefore, *not suited to India.*

"The basic right of convertibility that supports an exchange standard is *too abstract* for the present conditions in India. The backing which it supplies for the token currency is too *intangible* and *invisible.* Without some backing more simple, more certain and solid, confidence in the stability of the currency can grow more slowly than it should." Indian public opinion will have confidence only in *gold.* It would supply a real and visible link. They were thus led to the conclusion that it was necessary to establish a sure basis not only for the external, but the internal convertibility of the token currency of India *into metallic gold.*

(III) THE PROPOSAL FOR A GOLD CURRENCY :—Mr. H. Denning, the Controller of the Currency, presented a scheme for a gold currency before the Commission.*

The chief objects of the scheme were—

(*a*) to dethrone the rupee from its position as a standard coin of unlimited legal tender, so that the threat inherent in our present system of the rise in the price of silver would be eliminated ;

(*b*) to cure the uneconomical habit of the Indian people of

*This scheme was submitted in a Memorandum which represented the result of discussions which took place between Sir Basil Blackett (the Finance Member), Mr. McWatters (the Financial Secretary) and himself.

hoarding the precious metals as a store of value, by assuring them through the instrumentality of a gold currency, that *the same measure which they mete out, in gold value, by way of investment or deposit with a bank, will be meted to them again, in gold value.*

THE ESSENCE OF THE SCHEME :—The scheme had for its essence the gradual and cautious adoption of a gold currency for India within *ten years* by various stages beginning with the buying and selling of gold bars by the Government. For, in the first place, the rupee could not be made limited legal tender unless the present holders were given an opportunity to convert them into gold. The estimate made for this demand for conversion was Rs. 110 crores. Secondly, sufficient gold would have to be accumulated for the eventual adoption of a gold currency. The total amount of gold required for introducing the scheme in all its stages was estimated at Rs. 137.2 crores.

(2) The rate of exchange suggested was 1*s*. 6*d*. per rupee.

(3) And the management of Paper Currency and the conduct of Government remittance were to be handed over to the Imperial Bank of India.

In concluding that a *Gold Standard with a Gold Currency in circulation* was the only method of completely remedying the defects of the Indian Currency System within a reasonable period, Mr. Denning wrote in his Memorandum :—"There is, moreover, reason to suppose that the introduction of a gold currency would hasten the attainment of the ideal system, as the fact that notes were convertible into gold and not merely into an over-valued silver coin would tend to increase confidence in the note issue and to decrease the demand for metallic currency. The conclusion is that the only way of remedying all the defects in the system within a reasonable period is by establishing a gold standard with a gold currency in circulation."

THE GOLD CURRENCY SCHEME WAS REJECTED :—The Commission, after carefully considering the scheme, rejected it. They considered various important points in connection with this scheme.

(A) EFFECT OF INDIA'S DEMAND FOR GOLD :—In the first place, they took into account the effect of the absorption by India of enormous quantities of gold (estimated at Rs. 137.2

crores in addition to the normal demand for arts, hoards, etc.) on the supplies of credit, the rate of interest, and gold prices, throughout the world.

From the evidence which they received from eminent men like Professor Gustav Cassel and Mr. Joseph Kitchin, they were led to conclude that unless economy was exercised in the use of gold, a prolonged period of steadily falling commodity prices in the world was expected. Various European and other countries were trying to return gradually to the gold standard or the gold exchange standard after the war. To their demand for gold would be added the extra demand from India, which would cause increased competition for gold, and *lead to a substantial fall in gold prices and a susbtantial curtailment of credit.* And the fall in gold prices and curtailment of credit would on the balance be unfavourable for India.

Besides, it was expected that the United States of America was not in a position to spare the gold that India would need every year.

(B) UNCERTAINTY AS REGARDS AMOUNT AND TIME OF GOLD DEMAND :—It was also uncertain what amount of gold would be necessary for gold currency every year, nor was there any surety that the additional demand for gold would be spread over the period of ten years, as required by the scheme.

On the contrary, " there was the possibility of a *part of the notes being replaced by gold which had its own attractions for the Indian public.*"

That, the decline in the value of silver resulting from the proposal of gold currency would lead to a loss of confidence by the people, and its value would diminish as a store of value, and gold would be absorbed in much larger quantity for non-monetary purposes.

The estimate of the initial demand for gold laid down in the scheme was Rs. 50 crores. But the majority would not put reliance on this limit. For they considered that, as soon as it would become known that the status of the rupee was threatened, holders would probably get rid of every rupee they could spare and get the silver coins converted into gold coins.

In conclusion, if the amount of gold needed and the period of absorption of ten years increased, the difficulties would be

intensified and the cost of the project would be increased.

(C) RAISING OF THE REQUIRED CREDIT :—As regards the question of credits, Great Britain would not be able to act alone without the co-operation of America.

But the United States of America would not support a scheme which would give a death-blow to her silver market, for she has had traditional interest in silver, so that there would be unsurmountable difficulties in obtaining the necessary credit.

(D) EFFECT ON SILVER HOARDS :—They also considered the effect on silver hoards, which are the only store of value for the poorer classes. These are deeply interested in the value of silver bullion, and by instituting a gold currency their store of value would depreciate nearly 50 per cent. This would mean heavy losses for the poorer classes.

(E) EFFECT ON THE SILVER MARKET :—Besides, the *future of the silver market was* quite uncertain. However, from well-directed enquiries they came to the conclusion that there would be a diminution in its demand in the future. To add to this, if gold currency were resorted to by India, it would mean augmenting the demand for gold, which threatened to be in increasingly short supply, and would lead to a further depression of the gold price of silver.

CONCLUSION :—Sir Basil Blackett wrote in his memorandum, " if the effect of a decision to attempt the change to gold in India is going to be to upset the gold standard in the United States or in Europe, *India has clearly nothing to gain by the attempt.*" In the opinion of the Commission the attempt would be very likely to have the consequences to which he referred. It would upset the monetary standards of various countries and lead to higher interest rates and economic depression, which would react on India. They, therefore, rejected the scheme.

(IV) THE COMMISSION PROPOSED THE GOLD BULLION STANDARD :—Before outlining their scheme for a standard most suited to India, they emphasized the economic reasons against gold in circulation.

ECONOMIC REASON AGAINST GOLD IN CIRCULATION :—If gold in the reserve were transferred to circulation, the *structure of credit* that could be built on the reserve would

be *reduced* ; so that the greater the proportion of gold in circulation the less would be the elasticity of the currency system. The less the gold in circulation, the more will be the gold in the reserves and the greater the elasticity of the structure of credit that could be built thereon. "*Gold in circulation is of uncertain value for the support of exchange.*"

Consequently, the system they recommended for India may be described as the "*Gold Bullion Standard.*"

ITS ESSENTIALS :—The ordinary medium of circulation in India, they observed, should remain as at present—the currency note and the silver rupee. Although gold should *not actually circulate* as money, gold would be made the standard of value and the rupee would be linked to gold. "It *must* not circulate at first and *need* not circulate ever."

In order to secure this, *an obligation was to be imposed by law on the Currency Authority*—

(*a*) *to buy and to sell gold bars without limit* at rates determined by the fixed gold parity of the rupee ;

(*b*) but in quantities of not less than 400 fine oz. (*i.e.*, 1,065 tolas) ;

(*c*) *no limitation* being imposed as *to the purpose* for which gold was required. The fulfilment of this obligation would secure the stability of the gold value of the rupee and stability of exchange within specie-points.

Since gold bars were to be given in exchange for notes or silver rupees, *not for export only but for any purpose,* this was not an exchange standard. "It *is an absolute gold standard.* Nevertheless the compensatory mechanism of the exchanges is preserved, because gold bars are not currency." When gold bars are given by the currency authority in exchange for notes or rupees, the currency becomes *contracted ;* and when the reverse process takes place, the currency is *expanded.* It establishes the principle that "*gold is the standard of Indian currency at a fixed ratio, and that the currency authority admits it, and must maintain it.*"

THE LIMITATION IN THE CASE OF INDIA :—A sound gold standard postulates a statutory obligation upon the currency authority to buy and to sell gold at a price which is equal to the par value of the monetary unit.

This obligation constitutes "the *cardinal condition and com-*

pelling force" for the maintenance of the stability of the gold value of the rupee and through it the stability of exchange.

But, they stated, "in the case of India there is a difficulty in the way of imposing this obligation in this form". India demanded gold both for monetary and purely social uses, and this latter was to be seriously taken into account. "*For social uses India had always absorbed gold in important amounts,* and was likely to do so in important amounts in the future." In India at the time an admirably organized bullion market supplied the needs of the public for gold, and the price at which gold was sold included the cost of importing it and profits of the sellers. But if the currency authority were compelled to sell gold at a *price exactly equal to the par value of the rupee,* it would not take account of these items, and it would become the *cheapest market* for gold in India. Therefore, "not only would the bullion market be destroyed, but it would also be *extremely difficult to maintain the value of the monetary unit at parity with gold.* For in order to satisfy the demand for gold, the authorities would have to attract a steady flow of gold into its reserves, and the means to do so would be a *rigorous and continuous contraction of credit* which would be detrimental to the economic progress of India."

"It is essential, therefore, that the conditions which are to govern the sale of gold by the currency authority are to be so framed *as to free it in normal circumstances from the task of supplying gold for non-monetary purposes.*" In order to achieve this object, they made proposals for fixing the selling prices of gold. This, then, was to be the limitation in the case of India.

But India would retain complete freedom to buy gold in the bullion market which would remain the ordinary source of supply of gold for non-monetary purposes. The currency authority would not supplant the bullion market or be involved in supplying gold for ordinary *internal* demands for non-monetary purposes.

SUBSIDIARY RECOMMENDATIONS :—Various recommendations were also made by the Commission as a result of this adoption of the Gold Bullion Standard.

(1) *That the buying and selling of gold bars by the Government made it impossible to have any gold coin as*

legal tender. Thus the sovereign would have no place as legal tender.

(2) That in order to have some direct means of making the standard known to the masses, gold *savings certificates*, redeemable in three or four years and yielding interest to one who buys it, were to be issued.

(3) That *new notes* were to be issued which should be made *convertible into gold bars* and not in silver rupees. Thus a more solid right of convertibility was attached to them than they ever had before. But the old notes must continue to be converted into silver rupees.

(4) That *the coinage of the Rupee should be stopped* until the rupees in circulation were reduced to the amount required for small change. The object was to enable silver to be eliminated in course of years.

(5) That *one-rupee notes* should be re-introduced, but should not be convertible by law into silver rupees.

(6) That the *Reserves should be amalgamated and the proportions and composition of the combined Reserve should be fixed by law*. This was a provision essential to any currency system in order to secure the automatic expansion and contraction of the currency and their effect on the exchanges in accordance with the needs of the country. Thus they laid down *that gold and gold securities should form not less than* 40 *per cent. of the total.*

THE ADVANTAGES CLAIMED FOR THIS SCHEME :—The first great advantage claimed by the Commission for their proposed system was (1) that it was so simple that it would establish confidence in the stability of the currency very quickly. This standard fulfilled the essential condition that it should not be *stable* merely but *simple* and *certain*. It provided the token currency with a right of convertibility that was intelligible to the uninstructed, and with a *backing that was tangible and visible*.

(2) That those who advocated the introduction of a gold currency stated that a token currency of notes inconvertible for internal purposes was the ideal end towards which India should work. The scheme suggested by the Commission " carried India very far along the road towards the end. The scheme had the advantage of setting up almost immediately a full gold standard (as a preliminary to the ultimate adoption of gold currency)."

(3) That there had been general agreement that it was difficult to introduce gold currency at once. The alternative, therefore, was to make provision for the gradual strengthening of gold reserves in such a manner as to avoid disturbance to the world's gold and silver market, whilst incurring the minimum of expense. This would certainly not upset prices and disturb Indian business and trade. The scheme proposed would do this successfully.

(4) That apart from the economic loss to India, the existence of a large volume of currency in the hoards was a formidable obstacle to the efficient working of any currency system. As long as the circulating media of the country, whether silver coin or gold coin or notes, were employed for hoarding, the control of the currency authority over expansion and contraction of currency would be uncertain and there would be a possibility of fluctuation of prices. And the mere substitution in the hoards of one kind of coin for another was no remedy at all for this evil.

But the system "encouraged the habit of banking and investment by creating confidence and discouraged the habit of hoarding precious metals."

THE REAL VALUE OF THESE RECOMMENDATIONS :—In order to judge the value of the advantages claimed by the Commission for their scheme of a restricted "Gold Bullion Standard" it is necessary to analyse their proposals.

(A) EXTERNAL STABILITY OF THE RUPEE :—In order to maintain the *external* value of the rupee they proposed that the Reserve Bank (which will be the Currency Authority) shall be under obligation :

(*a*) to buy gold bars of not less than 400 fine ounces without limit when tendered in India at the par rate of Rs. 21-3-10 ps. = 1 tola (180 grs.) of fine gold. This is according to the *ordinary gold standard practice* and also pre-war practice in India ;

(*b*) to sell gold bars without limit for delivery in London at par rate plus a charge covering the total cost of shipment to London and loss of interest. These sales are intended to serve a monetary purpose when there is adverse balance of trade. This is *the common gold exchange standard practice* ;

(*c*) and to sell gold bars without limit for delivery in Bombay.

The gold in Bombay will be required for two purposes : (1) *monetary*, when a favourable balance of trade is to be liquidated and (2) *non-monetary*, for social uses. In this case there are limitations applied :—

(i) Gold will be sold at par rate (for monetary purposes) *only when exchange is at or above upper gold point* ;

(ii) but at all lower levels of exchange the selling charges for gold (for non-monetary purposes) will be par plus *twice* the shipping and interest charges (and not a single charge).

The effect of limitation (i) will be that at that point of exchange gold will flow into India in the ordinary course to liquidate the favourable balance of trade, so that it will not be very necessary for the Reserve Bank to sell gold.*

Whereas the effect of limitation (ii) will be to charge such a prohibitive rate that the public would not buy gold for non-monetary uses from the Reserve Bank, which will consequently preserve its gold stocks for purely monetary purposes. A deterrent rate is, therefore, applied. For the same purpose they have proposed certain rates making it cheaper to import gold from London than to buy it from the Bank when the exchange is *below upper gold point*. A method of computing the rates for buying and selling gold is laid down by the Commission in a special schedule.

The consequences of these proposals will be that (1) India's Standard will be based not on Sterling but on Gold. When the balance of trade is favourable to India, gold will be allowed to flow freely to India, and when the trade balance is unfavourable gold will flow out of India. (2) But the relation between the rupee and gold will be supported by the two obligations on the Reserve Bank to buy in India gold at par, and to sell gold in India for delivery in *London* at the rate proposed.

It will be seen from the above provisions that actually gold will *only be sold* by the Reserve Bank of India when, owing to an adverse balance of trade, *the exchanges turn against India* and gold is demanded by the public for meeting their foreign

* Even this is questionable. At 1s. 6*d*. rate the rupee price of one tola of fine gold is Rs. 21-3-10. But when the upper gold point is reached, i.e. when the exchange is 1s. 6$\frac{3}{16}$d., the rupee price of one tola of fine gold will be *less* than Rs. 21-3-10. If then the Reserve Bank offers to sell gold at the *par* rate of Rs. 21-3-10, who would buy gold from the Bank ?

obligations. The result is inevitable that there is no difference between the Gold Exchange Standard and the "Gold Bullion Standard" as proposed by the Commission and there is no room for the advantages claimed by them to exist in practice.

(B) INTERNAL STABILITY OF THE RUPEE :—As regards the internal stability of the rupee they proposed to solve satisfactorily the twofold problem :

(i) how to inspire the masses of India with confidence in the currency standard, which they have lost, and
(ii) how to remove once for all the threat to the currency system inherent in the price of silver—'the rupee melting-point'?

For the solution of this problem the measure they suggested was the establishment of *gold bullion as the backing for both notes and rupees* and therefore the ultimate withdrawal of the right of converting notes into rupees.

Their chief proposals were as follows :—

(1) The *new* notes of the Reserve Bank of India (guaranteed by the Government of India) and *rupees* both were to be *full legal tender* and convertible on demand with *bars of* **400** *oz. fine gold* (or **1,065** tolas),
   (*a*) *at par* when exchange is at or above upper gold point ;
   (*b*) but otherwise, *i.e.*, *normally*, at a *discount* (which is about 2¼ per cent. below parity as recommended by them in their detailed schedule).
(2) The *new* notes were *not* to be *legally convertible into rupees* but were to be freely encashed in practice, if people desired to exchange them for rupees.

It is indeed difficult to see how these limitations are going to inspire the masses of India with confidence.

(1) In the first place, in order to supply a backing for token currency which is 'tangible', 'visible' and 'intelligible' to the masses, the *greatest requirement is that token money whether silver rupees or notes, should be freely convertible into gold bars for internal use. But this is not provided for by the Commission.* The token money will in practice be convertible into gold bars for *export merely* and *not for internal use.*

(2) Secondly, *normally,* the new notes would be convertible at a *discount,* and as the rate for conversion would be fluctuating,

a gold note would not entitle the holder to receive a fixed quantity of gold in return. Besides, the minimum exchangeable weight of gold bars laid down is 400 oz. (1,065 tolas), *i.e.*, in value of nearly Rs. 22,600 at a time—a limit which is beyond the means of an ordinary purchaser.

For these reasons, in practice, it is impossible to expect that the new note will be in ordinary daily use in India. Its value will be in *foreign exchange*, but are the crores of Indians who form the masses at all concerned with foreign exchange ? From the point of view of convertibility, then, there is no difference between the present 'Gold Exchange Standard' and the proposed 'Gold Bullion Standard'.

(C) THE ESTABLISHMENT OF "THE RESERVE BANK OF INDIA" :—The second principal recommendation of the Commission was regarding the authority controlling the working of the standard. That authority, they wrote, should be a Central Bank, called "The Reserve Bank of India".

They made emphatic the following points :—

(*a*) That a Reserve Bank's monopoly of Note issue was absolutely necessary.
(*b*) That a Reserve Bank's Credit Policy was very necessary.
(*c*) That a Reserve Bank was necessary for Government's Banking business.
(*d*) That restrictions should be placed on the business of a Reserve Bank.

As regards the structure of the Reserve Bank they proposed a *shareholders'* constitution.

They did not recommend the transforming of the Imperial Bank of India, Ltd., which was already working as a semi-Central Bank, into a Reserve Bank for the important reason that it would be precluded from undertaking the ordinary commercial banking function and the country would, as a consequence, lose the benefit of the elaborate and widespread organization which it had set up. The Imperial Bank, in short, would have had to be *decommercialized*. Besides, this Bank with its branches spread over the whole of India, would be an ideal agent for the proposed Reserve Bank of India.

(D) ESTABLISHMENT OF THE PROPORTIONAL RESERVE SYSTEM OF NOTE ISSUE :—The Commission pro-

posed the establishment of the Proportional Reserve System of Note issue for India in place of the Fixed Fiduciary System which was existing then. The reasons for the adoption of the Proportional Reserve System and the details of this system have been incorporated in Chapter III to which reference is made.

(E) RATIO OF STABILIZATION : RATIO OF STABILIZATION TO BE 1*s*. 6*d*. :—For the reasons given below, the Majority recommended the rate of exchange to be 1*s*. 6*d*. for the rupee (in relation to gold).

I. ADJUSTMENT OF INDIAN TO WORLD PRICES :— (*a*) The chief reason they stated was that, at the exchange rate of 1*s*. 6*d*., prices in India had already attained a substantial measure of adjustment with those in the world at large, and that any change in the rate would mean a difficult period of readjustment. It would lead to widespread economic disturbance which had to be avoided.

If it could be shown that prices had to a great degree adjusted themselves to the existing *de facto* rate, then that rate must be adhered to and that such an adjustment had taken place was a *matter of fact*.

At the outset they recognized that "*index figures are not an infallible guide*, and that there are many directions in which they might lead one astray—*In India there are special difficulties in the way of compiling a representative* index figure owing on the one hand to the great size of the country and the cost of inland transport, and on the other to defects in the statistics on which the compilation is based."

Bearing the above reservations in mind, they proceeded to examine the data available to prove that 1*s*. 6*d*. was the *de facto* ratio, and in doing so, they took into account the indices of wholesale prices compiled at Calcutta and Bombay, and especially the former.

MUTUAL ADJUSTMENT OF PRICES AND EXCHANGE TO WORLD PRICE LEVEL

NO.	DURING PERIOD	RATE OF EXCHANGE (nearly)	RUPEE PRICE LEVEL	WORLD GOLD PRICES
1	December 1922—June 1924	1*s*. 3*d*. gold	176 (limits 170 and 181)	Approximately the same
2	July 1924—January 1925 —June 1925	Sharp rise to 1*s*. 6*d*. gold 1*s*. 6*d*. gold	Fell from 179 to 157	The period of adjustment
3	June 1925—March 1926	1*s*. 6*d*. gold	158 (limits 163-153)	Approximately the same at the end of the period.

The data given by the Majority have been arranged in a tabular form as above. Treating the statistics in the most generalized way and disregarding minor movements, the conclusions drawn by them were that—

(1) During the 18 months, while the rupee was worth about 1*s*. 3*d*. gold, the rupee price level ranged round a mean of about 176.

(2) In the succeeding year, while the rupee was rising to 1*s*. 6*d*. gold, the rupee price level *fell below* 160.

(3) Since then, while the rupee had remained, or had been held, at about 1*s*. 6*d*. gold, the rupee price level had ranged round a mean of *about* 158, with a recent tendency to fall in sympathy with world prices. But the *level of world gold* prices, as indicated by the wholesale price index figures of the United States of America and the United Kingdom, was (in spite of intermediate fluctuations) *approximately the same* at the beginning of period (I) and at the end of period (III).

CONCLUSION DRAWN :—Thus, " it is natural," they stated, " to conclude that, during the period of change, there was a mutual adjustment of prices and exchange, and that a substantial *equilibrium was attained* about the middle of 1925 and has been since maintained."*

(*b*) A further indication of the equilibrium between internal and external prices during the last 12 months preceding August 1926, was to be found in the *steadiness of exchange*. Exchange is the mechanism by which differences in these two price levels are adjusted and by which they are kept in unison. When exchange remains steady over a fairly long period, it may be inferred that there are no differences to be adjusted. Thus as the exchange was steady over a long period, it meant that the Indian prices had adjusted themselves to the world prices.

(*c*) It was relevant also to consider the course of India's foreign trade. It would naturally be affected by any disequilibrium between external and internal prices. But the general trade of the country taken as a whole showed no sign of the imposition of this disequilibrium. The foreign trade was steady and there were no adverse circumstances.

* They also showed the nature and extent of the tendency towards adjustment by means of graphs, and the reader is referred to paras 185, 186 and 187 of the Report.

II. ADJUSTMENT OF WAGES :—The Majority inferred on general grounds that considerable progress had been made in the process of adjustment of wages with the present level of prices and exchange. Prices were bound to react on wages and particularly so in India, because a much larger percentage of wages was spent on foodstuffs than in Western countries and that therefore there was a very necessary ultimate adjustment of wages to the price of foodstuffs. And this was true as recent history of Indian prices manifested itself.

Then again, were exchange and prices steady over a considerable period, one should feel justified in assuming that wages were in adjustment, unless there were any clear indications to the contrary.

The statistics of foreign trade strengthened the assumption. Nor was there any indication of any maladjustment of wages paid by manufacturing industries generally.

III. EFFECT ON CONTRACTS :—It was also relevant to consider how contracts would be affected by the 1*s*. 6*d*. ratio.

(*a*) In the first place, it was true that the Land Revenue and other long-term contracts were settled when exchange was at 1*s*. 4*d*., but they stated that, in view of the great rise in prices since 1914, the real incidence of Land Revenue measured in terms of commodities had been very materially lightened, and that the 1*s*. 6*d*. ratio would not be a hardship in this respect.

(*b*) Besides, it could be contended that contracts concluded prior to 1918 bulked more largely in the economic life of the country than those concluded after 1918, during which period the exchange was in a state of flux.

After the prolonged disturbances which had taken place, it was impossible to do justice to the long-term debtor or creditor by fixing any particular ratio of exchange.

Thus, they concluded that the least disturbance would be caused and least injury done to all interests by adhering to the *de facto* ratio.

MAJORITY'S CONSIDERATION OF THE ARGUMENTS FOR REVERSION TO 1*s*. 4*d*. RATIO :—(1) It was argued that 1*s*. 6*d*. rate came into being through Government manipulation of the currency, and that a rate so established could be disturbed with less harmful results than would follow from the disturbance

of the rate which has been produced by the interplay of purely commercial forces.

The answer of the Majority was that, in the first place, this was not supported by facts, and that in the final stabilization of the rupee it was the facts of the present that must be faced. When prices and other factors were in adjustment with those in the world at large on the basis of an existing exchange rate, the question of the means by which that rate came into existence had no bearing on the extent or violence of the economic disturbances which would result from an alteration in the rate.

(2) It was said that the 1*s*. 6*d*. ratio would accentuate the fall of prices in India resulting from the fall of world gold prices, such as took place in the year 1920.

But the Majority stated that this was quite unlikely to happen. The economic conditions of the time were very different from those that prevailed in 1920. Besides, if the world's gold production in the future should fail to keep pace with the demand, a period of falling prices would set in. But experience showed that the price movement due to such a cause would be slow and gradual.

Certainly India would suffer with the rest of the world from a long period of depression resulting from falling prices, but they stated that this risk would be there whether the exchange were at 1*s*. 4*d*. or at 1*s*. 6*d*.

(3) The Majority stated that the reversion to 1*s*. 4*d*. would affect the budget very much adversely and that immediately. They estimated the loss per annum at somewhere near Rs. 6 crores. This would certainly mean an increase in taxation, and also as regards the railway budget, an increase in rates and fares. And these in their turn would disturb the trade and the commerce of the country, and increase the cost of living of salaried servants.

(4) They stated that a reversion to 1*s*. 4*d*. would mean a general rise in prices of 12½ per cent., a change which would be severely felt by consumers generally, and specially by the poorer classes. It would also mean an arbitrary reduction of the real wages of labour.

(5) They stated that the effect of the change to 1*s*. 4*d*. on foreign trade would be immediate and for a time convulsive. The sudden fall in exchange might create a boom which would

be followed later by a slump.

(F) ARGUMENTS OF THE MINORITY : (I) IS 1*s*. 6*d*. THE *DE FACTO* RATIO ? :—Sir Purushotamdas Thakurdas, in his minute of dissent, stated that to fix the rupee at 1*s*. 6*d*., because it was the *de facto* rate, was a premise which was *not entitled* to the slightest weight. The reasons for this opinion were many. In the first place, the legal standard of money recommended by the Herschell Committee was 1*s*. 4*d*. to the rupee and this remained effective up to 28th August 1917, for a continuous period of nearly 25 years, and although it was disturbed during the war, it was the action taken on the Babington-Smith Committee that deliberately threw it out as the *de facto* ratio, and fixed an unnatural rate of 2*s*. gold.

THE OPPORTUNITY OF 1924 :—But when the attempt to stabilize it at 2*s*. gold was abandoned, and the rupee was allowed to adapt itself to the market conditions, it reached approximately 1*s*. 4*d*. *gold in September* 1924. Here then was an opportunity to stabilize the rupee at its long established legal standard of money payments ; but in spite of the suggestions in the Legislative Assembly to restore it, the Government of India declined to favour these proposals. Besides their telegram of the 11th October 1924 (when exchange was about 1*s*. ½*d*. gold) to the Secretary of State, " shows that their policy then was to look for, in other words, *a permanently higher rate than* 1*s*. 4*d*. *gold*. Subsequently, when in April 1925, the pound sterling reached gold parity, the Government of India were able to talk of this new ratio as 1*s*. 6*d*. gold, instead of 1*s*. 6*d*. sterling."

HOW WAS 1*s*. 6*d*. REACHED ? :—Further he considered how the rate of 1*s*. 6*d*. sterling was reached. According to him the rupee was maintained at 1*s*. 6*d*. by " *the official administration of the currency*." There was deflation of currency accomplished by preventing the expansion of the currency to the extent normally required by India, as was shown in the following table :—

Annual Average	Expansion of currency
Pre-war	Rs. 20 crores (and above)
1921-25	Rs. 11.12 crores

(*a*) DEFLATION OF CURRENCY :—It might be argued that deflation was necessary during that period in the interest of the country. But there were circumstances which went to prove that ***more currency was deflated than was required*** (or the normal expansion of currency was prevented).

(1) In the first place, the Imperial Bank of India rate went as high as 8 per cent. towards the end of 1923, and remained there for the first half of 1924.

(2) The fact that there was stringency in the market was even admitted by the Government to be the result of "the direct outcome of Government action in contracting currency, or rather in placing strict limits on possibilities of expansion."*

(*b*) NATURAL CORRECTIVE MADE IMPOSSIBLE :—Whilst the currency was being administered in this manner, the ***natural corrective to the rise in exchange***—the tender of gold at the currency offices—*was made impossible* for practical purposes by the retention of the fictitious ratio of 2*s*. on the statute book. The gold imported into India could not function as currency and was a mere commodity.

RATIO NOT ESTABLISHED SINCE OCTOBER 1924 :—Besides, the contention that 1*s*. 6*d*. ratio was the *de facto* ratio because it had been established since October 1924, had no truth in it. Sterling *had no parity with gold till June* 1925. From *October* 1924 *onwards the rupee was not* 1*s*. 6*d*. *gold*, but 1*s*. 6*d*. sterling. The rupee did not reach 1*s*. 6*d*. gold till June 1925, when sterling reached gold parity, and this rate had, therefore, prevailed only for a year.

(II) NO ADJUSTMENTS OF PRICES TO A 1*s*. 6*d*. RATIO : Sir Purushotamdas next considered the statistics produced by the Majority to prove that at the rate of 1*s*. 6*d*. per rupee, prices in India had already attained a substantial measure of adjustment with those in the world at large. He divided his examination of prices† into three main parts.

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* The Viceroy's telegram to the Secretary of State, dated the 8th October 1924. He also referred to a telegram of the Secretary of State to the Viceroy dated the 10th October 1924, in which he expressed himself as follows :—"It seems to me however, that the vital consideration is not so much the actual level of exchange at the moment as the avoidance of such abnormal stringency as might threaten the financial and economic position."

† "We had before us a statement from which I have taken the figures used by me in this note. The figures relied on by my colleagues are also based on the same statement." (Sir Purushotamdas Thakurdas.)

(1) PRICES FROM JUNE 1925 TO FEBRUARY 1926 :—After the rupee touched 1*s*. 6*d*. in June 1925, for six months there was a rise in the Calcutta Index Number. But sterling reached its pre-war parity in June, and the index number of sterling price was 158. Since then it steadily *fell* to 149 in February 1926.

Period	Calcutta Index Number	Sterling price
June 1925 ...	157 Steady rise	158 Steady fall
January 1926 ...	163	
February 1926 ...	158	149

Thus, as the table shows, while there *was a fall of* 9 *points* in the British Index Number, there was, on the contrary, a *rise* of one point in the Calcutta Index Number (when the rupee touched 1*s*. 6*d*. gold).

Then again, from the following table the conclusion becomes inevitable that the fall in the Bombay prices was due to the *fall in gold prices themselves over the world* and *not to any adjustment of the Indian prices to* 1*s*. 6*d*.

Period	Bombay wholesale prices (Index Number)	United States of America gold prices (Index Number)	United Kingdom gold prices (Index Number)
July 1925 ...	158	160	157
February 1926...	152	155	149

(2) THE COURSE OF PRICES FROM DECEMBER 1922 TO JUNE 1925 :—He then examined the contention of the Majority that the fall in rupee prices in the first half of 1925 represents " the tendency of those to adjust themselves to the rise in exchange." The figures given by him are arranged in the following table :—

* Period	% gold parity of the rupee	World gold prices (Index Number)	Calcutta prices (Index Number)
December 1922	95	156	176
June 1925 ...	113	157	157

The figures show that the *adjustment of Indian prices to world prices was only partial till June* 1925. Because, as gold parity rose 19 per cent. (from 95 to 113), the adjustment to be complete should have meant a corresponding fall of 19 per cent. in the Indian price level, *i.e.*, a fall of 33.5 points in the Calcutta Index Number. But the actual fall was of 19 points only (from 176 to 157).

(3) THE COURSE OF PRICES FROM JULY 1922 TO FEBRUARY 1926 :—He next took the whole range of price movements from July 1922 to February 1926.

Period	% gold parity of the rupee	World price level (Index Number)	Calcutta price level (Index Number	Average of Calcutta and Bombay (Index Number)*
July 1922 ...	90	155	181	185
February 1926...	144	155	158	155

The conclusions drawn from the above table are that the world price level was exactly the same at the beginning and end of this period. And when there was an *increase of* 27 *per cent. in gold parity* of the rupee there was *a fall* in the Calcutta Index Number of 23 *points*. But on a 27 per cent. increase in gold parity of the rupee, a *fall of* 49 *points should have occurred* to bring about complete adjustment of the Indian to the world prices. Thus a fall of 26 points, or *more than half the adjustment, was still to come in February* 1926.

Taking the average of the Calcutta and Bombay* Index Num-

*The Calcutta Index Number fell 503 points, a figure which corresponded very closely with the fall in the Bombay Number and strengthened the same conclusion.

bers we find a fall of only 30 points against 50 points (27 per cent. of 185) to be expected for full adjustment.

CONCLUSIONS :—Thus at the rate of 1*s*. 6*d*. per rupee, prices in India had *not* attained a substantial measure of adjustment with world prices, but the greater part of the *general adjustment* to 1*s*. 6*d*. *by a fall, had still to come.*

(III) NO ADJUSTMENT OF WAGES TO 1*s*. 6*d*. RATIO :—As regards wages, Sir Purushotamdas concluded that *no adjustment* either in agricultural, industrial or clerical wages had taken place, and none would hereafter, without a struggle. He proved the truth of his statement by the help of statistics.

(*a*) *Agricultural Wages* :—From the statement submitted by Mr. Ginnings of the Labour Bureau in Bombay, it was found that in the various divisions of the Bombay Presidency *the increase* in the wages of labour between 1913 and 1925 was as follows :—

Areas	Class of labours	*Percentage Increase*
I—Rural ...	Field	106
,, ...	Ordinary ...	86
,, ...	Skilled	109
II—Urban ...	Field	121
,, ...	Ordinary	104
,, ...	Skilled	116

In the absence of any other data, these figures, he concluded, might be taken as representing the general agricultural wage level in India, there being no evidence of a decline in wages from any part of the country.

(*b*) *Industrial Wages* :—Regarding the industrial labour, the figures submitted were as follows :—

Industry	Index number for 1914	Index number for 1925
Bombay Cotton Mill ...	100	232
Jute Mill	100	150

From no part of India was there any suggestion that the industrial wages had a tendency to *fall*. Besides, increase in *wages lagged behind* the rise in prices since 1914. The variations in the Jute mills in Bengal were shown as follows :—

Date	Index Number of Calcutta wholesale prices (30th July 1914=100)	Wages (1913=100)
May 1918	173	110
January 1920 ...	218	140
April 1925	169	150

This illustrated the very slight connection, over a considerable period of time, between variations in the cost of living and in wages. He also laid stress on the inability of the industrial wage-earner to reconcile himself to any decrease in wage, even on the ground of the appreciation of the rupee in gold, as was proved by the strikes of the Bombay mill-hands in 1923 and 1925.

Even with regard to the employees on the State railways there had been no reduction in wages. Thus, in the North-Western Railway Locomotive Workshops at Lahore, the average increase in monthly wages of unskilled workmen in 1922 was 220, nor was it suggested by any official witness that the Government had contemplated any reduction in the wages of their employees on the ground of the appreciation of the rupee in relation to gold.

(*c*) *Clerical Wages* :—The official figures supplied with regard to wages of clerks, in the City of Bombay in 1924, showed a percentage increase of nearly 77 over 1914.

CONCLUSIONS :—The Indian cost of living index number in March 1926 was 155. Any increase in this cost consequent on a reversion to the 1*s*. 6*d*. ratio (even assuming that adjustments to 1*s*. 6*d*. had fully taken place) would not exceed 12½ per cent., even then there would remain a *clear margin to cover*, as was shown by the figures of wages (except in the case of the labourer in the Jute mills and mines in Bengal). "Besides, an adjustment in wages to the 1*s*. 6*d*. basis, if it has to be enforced, will therefore entail a long and bitter struggle between Labour and Capital, with consequent disturbance in the economic organization of the country."

(IV) EFFECTS ON CONTRACTS :—Sir Purushotamdas next considered the effects on contracts. It had been urged that a change to 1*s*. 4*d*. would prejudicially affect the outstanding contracts of a short-term character. He refuted the argument by considering the effect on various forms of contracts.

(*a*) *Commercial contracts* :—It was acknowledged that for all commercial transactions exchange could be *covered* for a period of 12 months ahead. If a businessman kept his contract open, it would be his own fault. And particularly since 1924, when it was widely known that the statutory 2*s*. ratio was to be changed, no careful businessman could be justified in not covering his exchange.

(*b*) *Industrial and commercial borrowing* :—The industrial and commercial corporations borrowing over a period of 20 or 30 years, would not be prejudicially affected by having to meet obligations at the gold value of the rupee at 1*s*. 4*d*., *if they entered in their obligations before* 1917. It was only those who borrowed since 1917, who would be affected by the ratio 1*s*. 4*d*. But these could not be very large. But after the war, for some time, fluctuations were unavoidable, and then the failure of the Government to maintain the 2*s*. ratio led to such serious fluctuations in the exchange that those, who made contracts during these years of fluctuations, were likely either to suffer or to gain by instituting *any* ratio at present.

(*c*) *Agricultural indebtedness* :—But the indebtedness of the Indian agriculturist and the masses demanded serious consideration. Mr. M. L. Darling, I.C.S. of the Punjab, estimated the rural indebtedness of British India at Rs. 600 crores. It was probably Rs. 200 crores for Indian States. As the rate of exchange between 1900 and 1917 was round 1*s*. 4*d*., it was only right to assume that most of this debt of Rs. 800 crores was contracted when the rupee was 1*s*. 4*d*. gold. Now to fix the exchange at 1*s*. 6*d*. gold would practically mean putting a burden of 12½ per cent. on these borrowers. This is a class whose case should have the first consideration in dealing with the effects of 1*s*. 6*d*. ratio.

Under the heading of contracts, therefore, " the higher figure of 1*s*. 6*d*. has little to recommend it, and very much against it."

(V) EFFECT ON FINANCE OF THE CENTRAL GOVERNMENT :—The most serious item to be considered was the alleged gain from 1*s*. 6*d*. of Rs. 3.16 crores in the General Budget (Railway Budget is separated from it). As against this, there was to be put an increase of Rs. 2.62 crores in customs on stabilization at 1*s*. 4*d*. Besides, account must be taken of the decrease under bounties to certain industries given on the rise of exchange to 1*s*. 6*d*., so also an increase in receipts under Income-Tax and Corporation Tax, owing to industries being spared the disturbance incidental to 1*s*. 6*d*., bearing in mind that Joint Stock companies pay very nearly 15 per cent. out of their profits under Income-Tax and Corporation Tax.

This clearly showed that the claim of a gain by 1*s*. 6*d*. was exaggerated. However, this unearned increment in the Government of India Revenue Budget would exist as a tangible and visible asset only during the period of non-adjustment, and would vanish when adjustment was complete. Moreover, during the period of non-adjustment, while there was a tangible gain to the exchequer, some one paid for it—*"It is the producer who has to accept so many fewer rupees for the produce he has to sell."**

(VI) LARGER RESOURCES NECESSARY TO MAINTAIN 1*s*. 6*d*. RATIO :—The question to be decided was whether it was necessary to fix a ratio that would require larger resources to maintain, if the fixing of the ratio could be avoided. A little lull in the export trade from March 1926, necessitated resort to deflation in India to the extent of Rs. 8 crores to maintain the exchange, and to the offer of sale of the Reverse Councils at 1*s*. 5¾*d*. That was enough evidence to prove that larger resources would have to be required to maintain the ratio.

(VII) ALLEGED EFFECT OF REVERSION TO 1*s*. 4*d*. :—The Majority apprehended that a reversion to the 1*s*. 4*d*. ratio would lead to a rise in price to the full extent of 12½ per cent. of articles given and consumed in India, and as a consequence, hit the poorer members of the literate class and consumers generally, because prices had substantially adjusted themselves to the 1*s*. 6*d*. rate.

To this the answer given by Sir Purushotamdas was that he had conclusively proved that no adjustment of prices to 1*s*. 6*d*. ratio

* Sir Purushotamdas quoted the words of Mr. Robert Campbell and Sir John Muir in their supplementary note in the Fowler Committee Report.

had taken place, and that the major part of it was still to come. Hence, any disturbance that might ensue from the fixation of the lower ratio would produce a very insignificant disturbance in economic conditions, injurious to but a few, if any at all. "Besides, as regards the burden likely to be imposed, if 79 per cent. of the people of India subsist on agriculture, it is difficult to understand the concentration of my colleagues on the interests of the other 21 per cent. who live on the production of this class."

(VIII) CLAIM OF THE DEBTOR CLASS :—Besides, a change to 1*s*. 6*d*. would hit the large bulk of the *debtor class*, to the benefit of the creditor class. He stated, "I cannot conceive of any valid or moral reasons for a step calculated to give the latter an unearned increment at the expense of the former. In India, perhaps more than anywhere else, the debtor class is the largest and the neediest, for whom the Government has always evinced concern and solicitude. What unavoidable reason, then, is there to hit *this* class ?"

(IX) SUITABILITY OF THE 1*s*. 4*d*. RATIO :—*Finally, 1s. 4d. was the ratio that stood for 20 years,* even during the American crisis, till 1917, and was only disturbed as a result of the war in common with the ratios of other countries in the world. It could not lightly be said to be a ratio that was unnatural to the Indian system. No other country had adopted a rate of exchange higher than its pre-war rate. Even Great Britain did not change her standard when the £ sterling dropped to 3.38. Other countries had made great sacrifices to return to their pre-war ratios, which was the proof of the sanctity attaching to them. "But in India, it is not a question of making a great sacrifice to regain her 'permanent rate'. It is, at worst, a question of balancing the disturbance which may be caused by a reversion to 1*s*. 4*d*., and an adoption of 1*s*. 6*d*."

CHAPTER XX

The Currency Act, 1927

Fixation of the 1s. 6d. ratio and imposition of a statutory obligation upon the Currency Authority to purchase gold and sell gold or sterling.

TRANSITIONAL MEASURES ADOPTED :—The first fruits of the Report of the Hilton-Young Commission was the passing of the Currency Act, 1927. This Act embodied merely those measures which the Commission recommended for the *transitional period*. It was purely an interim measure which was intended to cover a period between the time when the Act was passed (April 1927) and the time when the "Gold Standard and Reserve Bank of India" Bill, which was placed before the Legislative Assembly was expected to come into effect. But this Bill had a chequered history and having passed through nearly five stages in its career was ultimately dropped on 13th February 1928.*

The Currency Act, 1927, therefore existed as a *transitional measure*. It did *not* touch the question of the Gold Bullion Standard at all. In the words of Sir Basil Blackett, the late Finance Member, "It does not do anything more than provide for an interim period during which the standard will be a gold exchange standard."†

The clauses of the Act were in substance as follows :—

I. THE RATIO FIXED AT 1*s*. 6*d*. :—In the first place, it amended the Indian Paper Currency Act, 1923. Under this Act the rupee was valued at 11.30016 grains of gold, *i.e.*, it corresponded to a rate of exchange of 2*s*. for the rupee. But the Currency Act of 1927 altered this value to 8.47512 grains of gold per rupee, *i.e.*, the *exchange value* of the rupee was fixed at 1*s*. 6*d*.‡

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* The history of Gold Standard and Reserve Bank of India Bill is fully traced in the Author's: *A Reserve Bank for India and the Money Market*, Chapter XV.

† *Legislative Assembly Debates*, Vol. IX—No. 35, page 2110.

‡ Considering the scope of this volume an apology from the Author will, it is hoped be readily accepted by the reader for not having included in it an account of the various arguments for and against the 1*s*. 6*d*. ratio which were put forward by the legislators before the Legislative Assembly when the Bill was being discussed. But most of these arguments arrayed were deductions from those principally stated by the Majority and the Minority of the Royal Commission of 1926, and on 8th March 1927, an amendment to fix the ratio at 1*s*. 4*d*. (instead of 1*s*. 6*d*.) was lost by 65 votes against 68.

For a full account, reference is made to *Legislative Assembly Debates*, Vol. VIII—Nos. 2 and 5; Vol. IX—Nos. 30, 31, 36, 38, 39, 40.

II. SOVEREIGN AND HALF-SOVEREIGN NO LONGER LEGAL TENDER :—In the second place, under the Indian Coinage Act, 1906, and the Indian Paper Currency Act, 1923, the sovereign and half-sovereign were legal tender at the rate of Rs. 10 per sovereign.

But the Currency Act, 1927, *took away the legal tender character of the sovereign and half-sovereign in India altogether.* This was done in accordance with the recommendation of the Royal Commissioners who wrote that the sovereign and the half-sovereign should be demonetized in order to enable the new 'gold bullion standard' to come into force. In supporting this argument in the Legislative Assembly, Sir Basil Blackett said, "It is quite a different thing to take away the legal tender character from a coin which is not in fact in actual circulation at all, which has not circulated for some years. It is quite another thing, after having given it a legal tender character now, to take away that legal tender character 5 or 6 months hence. The matter is perfectly open to the House to decide in connection with the Gold Standard and the Reserve Bank Bill".* On this ground then the sovereign and half-sovereign were demonetized.

III. STATUTORY OBLIGATION TO PURCHASE GOLD AND SELL GOLD OR STERLING :—In the third place, the Currency Act, 1927, imposed *for the first time* on the Government (the currency authority) *a statutory obligation* :

(*a*) to *purchase* gold bullion tendered by the public for sale in the form of bars containing *not less than forty tolas* of fine gold at the rate of Rs. 21-3-10 per tola of fine gold (*i.e.*, at 1*s.* 6*d.* = Re. 1) ;

(*b*) (1) *to sell* to any person who makes a demand in that behalf, *gold* for delivery at the Bombay Mint at the rate of Rs. 21-3-10 per tola of fine gold *or*, *at the option* of the Controller or the Deputy-Controller, as the case may be, *sterling* for immediate delivery in London at an equivalent rate :

Provided that no person shall be entitled to demand an amount of *gold* or *sterling* of less value than that of 1,065 tolas of fine gold.

(2) For the *purpose of determining the equivalent rate applicable to the sale of sterling* the Act stated that

* *Legislative Assembly Debates*, Vol. IX—No. 38, page 2394.

Rs. 21-3-10 shall be deemed equivalent to such sum in sterling as is required to purchase 1 tola of fine gold in London at the rate at which the Bank of England is bound by law to give sterling in exchange for gold, after deduction therefrom of an amount representing the normal cost per tola of transferring gold bullion in bulk from Bombay to London, including interest on its value during transit. This rate was to be determined by the Governor-General-in-Council from time to time and notified accordingly.

This clause needs some interpretation. It had, as stated above, *for the first time* placed a statutory obligation on the Government of India (so long as it remained the Currency Authority), to buy gold at the fixed parity of the rupee and to sell gold or *sterling* at their option at the upper and lower gold points corresponding to that fixed parity. It may be recalled that in the system as it existed before this Act came into operation, the provision requiring the Government to give rupees in exchange for gold operated to prevent the exchange rising above the fixed rate. But there was *no statutory obligation on the Government to prevent the rupee falling below the fixed rate*, so that the link between the rupee and gold was imperfect. And it was left to the discretion of the Government to take any steps, such as the sale of the Reverse Councils, to prevent the rate falling.

By the Act this discretion was no longer possible and it would be no longer *within the power of the currency authority to let exchange stray away from the fixed rate* "without coming within the mischief of statutory provisions of an Act of the Indian Legislature."* The Royal Commission laid great stress on this part of their recommendation and wrote : "We desire expressly to emphasize that this recommendation as to the transition period is of the essence of our proposals. The Government of India should at once publicly announce its acceptance of the obligation as defined and should fulfil it without variation during the period of transition. We are of opinion that this obligation should be embodied in a statutory form."†

Thus the statutory enforcement of this obligation to maintain the rupee within its fixed upper and lower points was the essence

* Sir Basil Blackett in his speech before the Legislative Assembly.

† Paragraph 166 of the Report.

of this Act. And this statutory obligation on the Currency Authority to *purchase gold* but *sell gold or sterling at their option* at fixed rates in order to maintain the exchange value of the rupee, established the *gold or sterling exchange standard on a firmer basis during the transition period.*

Another part of this clause needing an explanation was that concerning the actual quantity of gold which the Act compelled the Currency Authority to purchase and sell. The minimum quantity of gold which it could *purchase* when offered to it for sale by the public was fixed at 40 tolas (or 15 ounces) instead of 1,065 tolas (or 400 ounces) as recommended by the Royal Commission. This was done to enable the poor people and the petty merchants to avail themselves of the system, as the quantity so reduced would be within their easy reach. The quantity 1,065 tolas was too heavy, regard being had to the circumstances and conditions obtaining in India.

But the quantity of gold or sterling which the Currency Authority shall sell was fixed at 1,065 tolas. This was done, in accordance with the recommendation of the Royal Commission, to prevent gold from being demanded by the public for non-monetary purposes. And the *option given to the Currency Authority to give gold or sterling made the standard a gold or sterling exchange standard.*

SUMMARY :—By the Currency Act, 1927 :

(1) the rate of exchange was fixed at 1*s.* 6*d.* ;
(2) the sovereign and half-sovereign were demonetized ;
(3) a statutory obligation was imposed on the Currency Authority for the first time to *purchase gold* and *sell gold or sterling* to the public when demanded by them. Thus the gold or sterling exchange standard continued to exist.

CHAPTER XXI

Indian Currency and Exchange during 1927-1931

PRINCIPAL WORLD FACTORS AFFECTING INDIA'S ECONOMIC CONDITION :—The four years which followed the passing of the Currency Act of 1927 could, in common with other countries of the world, be divided into two almost clearly marked periods : (A) During the first two years and a half *ending with September* 1929, there was a general improvement in economic conditions in most countries of the world, although during the last four months depression in world trade had already begun.

(B) But the period following September 1929, had been one of a *monotonous fall in general prices and of an unprecedented depression in industry and trade.*

It is therefore relevant to give a survey of the principal world factors which had contributed to affect the economics of India.

(A) During the official years 1927-28 and 1928-29 there was a movement of European Governments towards the stabilization of their currency systems. Thus, Italy returned to the gold standard and the French Government, in order to stabilize the French exchange, fixed the legal value of the franc. These factors tended to remove serious obstacles to the rehabilitation of the trade of Europe. Great Britain emerged from the depressing effects of the prolonged coal strike of 1926-27 and the prospects of her trade and industry improved. In November 1928, a currency reform of great importance took place in England. The notes issued by the British Treasury and the Bank of England were amalgamated. These measures, combined as they were with provisions for increasing the centralization of the various national currency reserves, brought the monetary systems of the world into still closer contact and paved the way towards trade prosperity.

On the other hand, in Japan there was a severe banking crisis in April 1927, which necessitated the declaration of a moratorium by the Japanese Government, and although financially the country

made considerable progress towards rehabilitation during the following year, the stability of the Yen was not attained. These factors affected India principally by their reactions on cotton exports and on silver prices.

Further, the steps taken by the currency authorities in the United States of America to control the expansion of credit in that country had wide international repercussions. In July 1928, the Federal Reserve discount rates were raised and other measures were also taken to make credit dear, which gradually began to attract short-term money from other world centres to the United States for investment. To prevent this drain of money to the United States and to protect the exchange there was a general world movement throughout the year towards higher bank rates.

(B) This movement continued during the greater part of 1929, and during this and the succeeding year, world finance, commerce and industry were chiefly influenced by *the speculation in the stock exchanges of the United States of America*, and the measures taken by the Federal Reserve Board to curb it.

But this boom broke in the United States at the end of October, shortly preceded by a collapse of a similar though less violent boom on the British Stock exchanges. These gave a terrible shock to world's commercial activity, and the consequent reluctance to manufacture or buy, brought about *a large drop in the wholesale prices of commodities*. This tendency was aggravated by the large withdrawals of gold by certain European countries, principally France and Germany into their currency reserves. The general fall in wholesale prices continued uninterruptedly up to March 1931, and had catastrophic effects on world trade.

The extent of this fall can be seen in Statement I.

STATEMENT I

INDEX NUMBERS OF WHOLESALE PRICES

	INDIA		United Kingdom	United States of America
	Calcutta (*a*)	Bombay (*b*)	(*c*)	(*d*)
1928, April ...	146	142	143	97
1929, March ...	143	147	140	98
1928, September ...	***143***	***147***	***136***	***98***
1930, March ...	125	137	125	91
1930, September ...	111	120	116	84
1931, March ...	100	111	106	75

One of the most remarkable features of the collapse of the speculation boom in the stock exchanges of the United States was the effect on rates of discount ruling in the three most important international money markets. The Federal Reserve Bank re-discount rate reached the lowest level of 2 per cent. on the 23rd December 1931, and the Bank of France rate was reduced from time to time until it reached 2 per cent. from the 2nd January 1931. The Bank of England rate too was reduced to 3 per cent. on 1st May 1930, and remained at that figure throughout the rest of the year.

Two other important events during 1930-31 which had repercussions on world finance were, the large number of bank suspensions in the United States and the so-called Oustric collapse in France. Both of these tended to retard a return of confidence. The Oustric affair led to a large repatriation of foreign investments and as a consequence heavy withdrawals of gold from London and America on French account. Thus, during the year the gold holding of the Bank of France increased from 42,557 million francs to 56,116 million francs. Japan too suffered as much as other countries from a fall in the price level, unemployment and a heavy decline in exports.

I. INDIAN FOREIGN TRADE AND EXCHANGE : (A) DURING 1927-28 AND 1928-29 :—In India during the two years there was a general improvement in economic conditions. The only disquieting feature in 1928 was the strikes in the cotton

mill and steel industries which continued until the cold weather. But for this, the trade and commercial conditions in this year would have been more favourable than in preceding years. The monsoons were on the whole good, crops were large and foreign demand for the export staples was also good leading to a steady increase in the value of exports as shown in Statement II.

STATEMENT II

BALANCE OF TRADE IN PRIVATE MERCHANDISE

(in lakhs of rupees)

	1926-27	1927-28	1928-29	1929-30	1930-31
Exports ...	+3,01,43	+3,19,11	+3,30,13	+3,10,80	+2,20,46
Re-exports (of foreign merchandise)	+8,01	+9,54	+7,83	+7,13	+5,14
Imports ...	—2,29,98	—2,46,78	—2,51,49	—2,38,95	—1,63,62
Balance of Trade...	+79,46	+81,87	+86,47	+78,98	+61,98

The result of the increase in the value of exports was greater strength in exchange which actually reached the upper gold point in December 1927, and in January and November 1928. The Government could therefore with ease make remittances by the new method of purchasing sterling by public tender in India. The sterling purchased in India by the Government during 1927-28 was to the amount of £28,325,000 and in 1928-29 it was worth £30,810,000.

But these remittances were insufficient to meet the requirements of the Secretary of State and had to be supplemented by such means as (1) drawings on the sterling reserves, (2) issue of India Bills in London, (3) issue of sterling loans in London, (4) issue of Treasury Bills in India in large amounts.

(B) DURING 1929-30 AND 1930-31 :—India being a country where general economic well-being is still very dependent on the

world demand for her agricultural produce, could not hope to escape the serious effects of the world factors narrated above. Although the monsoon was adequate and harvests good during the two years the collapse in world prices and the world depression in trade influenced Indian exports considerably as is shown in Statement II. The effect of the civil disobedience campaign could not be ignored in this connection.

EXCHANGE DURING 1929-30 :—The reaction of these factors on Indian exchange was inevitable. It was generally weak and the Government had considerable difficulties in purchasing sterling to make remittances to the Secretary of State. For several weeks no tenders were made at all.

Therefore, Treasury Bills had to be issued continuously and *contraction of currency* had to be brought about at certain times, in order to tighten up money. "The issue of Treasury Bills enabled the Government not only to maintain the exchange value of the rupee without selling gold or sterling but to purchase a fair amount of remittance towards meeting the requirements of the Secretary of State."* These factors, combined with the rise of the Imperial Bank of India rate to 7 per cent. in October, enabled the Government to make good purchases.

But with the sudden and heavy fall in the prices of commodities consequent on the collapse of the stock exchange boom in New York, the Government's difficulties in purchasing sterling increased and they were compelled to pay a high price for sterling and generous rates for selling Treasury Bills. But the exchange continued to remain weak at 1*s*. 5$\frac{13}{16}$*d*., throughout March 1930. In all the Government was able to purchase sterling to the amount of £15,215,000, and a further £11,825,000 was transferred to the Treasury balances of the Secretary of State in London against an equivalent contraction of currency. In order to meet the Secretary of State's further requirements of £18 millions, sterling bills and a sterling loan had to be floated in London.

EXCHANGE DURING 1930-31 :— Up to July 1930, although the exchange recovered from time to time, it became definitely weak from that month to October. The highest rate touched in August and September was 1*s*. 5$\frac{25}{32}$*d*., and the lowest 1*s*. 5$\frac{3}{4}$*d*., notwithstanding that "Treasury bills were sold freely

* Report of the Controller of the Currency, 1929-30, page 8.

throughout this period and contractions to the extent of Rs. 20 crores were made against rupee securities."* And purchase of sterling became very difficult. At this time the civil disobedience movement was in full swing and business was paralysed.

On the 19th November no tenders were received by the Government who had to announce their withdrawal from the market for the time being. The middle of November saw the beginning of a distinct change for the worse. A period of consistent weakness set in which lasted until the end of February and the Government were unable to purchase sterling during these months.†

On the contrary, "a demand arose *for the sale of sterling* by the Government at the statutory rate of 1*s*. $5\frac{49}{64}d$. The market was governed practically in toto by the political situation throughout this period and the amount of sterling sold between November and March totalled £5,650,000." But when the political situation was eased exchange began to gain strength and reached 1*s*. $5\frac{7}{8}d$. in the end of March.

During the year 1930-31 sterling to the amount of only £5,395,000 was purchased through the market. It was, therefore, necessary to meet the Secretary of State's requirements by other means, such as remittance through the Paper Currency Reserve or by borrowing in London. Sterling loans to the extent of £31 millions had to be raised in London. *And the entire holding of the Paper Currency Reserve in England including sterling securities were transferred to the Home Treasury primarily to meet sales of sterling against corresponding contraction of rupees in India.*‡

II. CONTRACTIONS OF THE CURRENCY, SALES OF TREASURY BILLS AND MONEY RATES :—The monetary situation in the United States of America, particularly after the collapse of the speculation boom in the country in September 1929, actually affected money rates in the world. As stated previously, contraction in the demand for money caused by the prevailing low prices, stagnant stock markets, smaller borrow-

* Report of the Controller of the Currency, 1930-31, page 13.

† This was partly due to the fact that rumours were fully circulated to the effect that one of the recommendations made to the Round Table Conference, which was to meet on the 12th November, was that a remission would be made to the old statutory 1*s*. 4*d*. ratio—Report of the Controller of the Currency, 1930-31, page 14.

‡ Report of the Controller of the Currency, 1930-31, page 14.

ings by traders, and the nervousness of the banks for loaning money resulted in a marked decline in discount rates as shown in Statement III.

STATEMENT III

BANK RATE %

	1927 (end of December)	1928 (end of December)	1929 (end of December)	1930 (end of December)	1931 (14th February)
London ...	4½	4½	5	3	3
New York...	3½	5	4½	2	2
Calcutta ...	7	7	7	6	7

Statement III shows a well marked difference between the Calcutta Bank rates and those in London and New York, the former being considerably higher than those in the latter countries. The reason for this marked disparity are given by the Controller of the Currency who stated : "Low money rates in highly developed industrial countries do not necessarily imply a similar state of affairs in agricultural countries whose staple trade consists in the export of the raw materials of commerce. Given satisfactory harvests in such countries prices of agricultural products are the first to fall resulting in redundancy of floating money, disequilibrium of prices, and an undue strain on the foreign exchanges. It is clearly necessary in such circumstances to take measures to ration credit and to control money rates until equilibrium is restored."*

Under the circumstances during 1929-30 and 1930-31 the Government of India had to take measures to control the short money market and to withdraw redundant funds by (1) continuous issues of Treasury bills and (2) contractions of the currency. The Bank rate of the Imperial Bank of India had to be raised from time to time.

*Report for the year 1930-31, page 2.

The extent of the contractions of the currency brought about during the last four years can be judged from Statement IV.

STATEMENT IV

TOTAL EXPANSIONS AND CONTRACTIONS OF CURRENCY DURING THE PERIOD 1926-27 TO 1930-31

Expansions + or Contractions —

(in lakhs of rupees)

1926-27	1927-28	1928-29	1929-30	1930-31
—29,25	—4,10	+1,90	—32,41	—38,64

During the last two official years there began a serious *outflow of capital from India* due chiefly to three causes : (1) the seasonal weakness of the demand for money, (2) the more important tendency created by the political situation of the country to sell investments in India and take the proceeds out of the country, and (3) the tendency on the part of cautious investors to spread their risk by investing part of their capital abroad. To prevent the outflow of funds during these years large amounts had to be withdrawn from the market and the means adopted to do so was the continuous issue of Treasury bills.

The fact that during 1929-30 for nearly 197 days of the year and during 1930-31 for nearly 247 days of the year Treasury bills were sold, designates the important part these bills played in controlling money rates. Statement V shows the total of Treasury bills outstanding at the end of the month of each year.

STATEMENT V

TREASURY BILLS OUTSTANDING

(in lakhs of rupees)

AT THE END OF EACH MONTH	AMOUNT
April 1928	12,17
March 1929	3,99
September 1929	26,78
March 1930	36,03
September 1930	49,06
March 1931	55,37

III. CONTINUOUS AND HEAVY FALL IN THE PRICE OF SILVER :—Another noticeable feature of these years was the almost uninterrupted and heavy fall in the price of silver. The predominant factor in influencing the price of this metal was the situation in China. The remarkable firmness of price in 1928-29 was due to the continued absorption of the metal by China, but towards the close of the year the large increase in stocks in Shanghai was already beginning to exercise a depressing effect, which steadily increased throughout the year. Since then there was a continuous downward movement. The price fell steadily from Rs. 58-13-0 per 100 tolas in April 1928 to Rs. 41-5-0 as in March 1931.

The main cause of the fall was the happenings in China. Owing to the fact that that country had been subject to political disturbance and warfare for several years past, its exports had declined, and in order to pay for imports, large amounts of silver had to be sold. The effect on the world price was necessarily great.

IV. SALES OF SILVER BY THE GOVERNMENT OF INDIA AND IMPORT DUTY ON SILVER :—Consideration must also be given to the fact that during the four years the Government of India sold silver from the Paper Currency Reserve. The Hilton-Young Commission found the silver holding unduly large, and recommended its gradual reduction from Rs. 85 crores to Rs. 25 crores during the transition period of 10 years, and

stated that "no favourable opportunity of fortifying the gold holding in the Reserve should be allowed to escape." Following up this recommendation the Government of India sold silver from time to time, until from the commencement of their operations in 1927 the total sales amounted approximately to 101 *million fine ounces* by the end of 1930-31. With the price of silver persistently falling, loss must have been incurred by these sales. In the absence of any statistical data it is difficult to estimate the loss.

CHAPTER XXII

Linking the Rupee to Sterling and subsequent developments upto the outbreak of World War II

The Rupee was linked to Sterling (24th September 1931)

(*a*) THE DEEPENING OF THE ECONOMIC DEPRESSION :—The world economic depression which had started since the break on the New York Stock Exchange in October 1929 continued unabated during the succeeding years, until in the early summer of 1932, economic activity in the world as a whole had touched depths unprecedented during the depression. The figures in Statement VI show clearly, not only the extraordinary shrinkage of world trade, but the acceleration in the rate of decline from year to year.

STATEMENT VI

TOTAL VALUE OF WORLD TRADE, 1929-1932

($ 000,000's)

Year	Total Value
1929	68,641
1930	55,575
1931	39,769
1932	26,611

Whatever may be the causes, monetary, non-monetary and political, which led to the depression, it was certain that the most important and immediate cause had been the catastrophic fall in the price of commodities expressed in terms of gold. Statement VII shows the extent of the fall in prices in certain important countries.

STATEMENT VII

WHOLESALE PRICE INDICES OF CERTAIN COUNTRIES

(Base: 1913 = 100)

Country	Peak in 1929	March 1933	Percentage decline from peak to	
			the lowest point	March 1933
United States of America ...	138.2	86.2	38.0	37.6
United Kingdom ...	140.3	97.6	30.4	30.4
Japan ...	172.2	134.0	35.8	22.2
India ...	***149.0***	***83.0***	***44.3***	***44.3***
Australia ...	170.8	122.5	28.5	28.3

The fall in prices more gravely affected the raw-material producing countries than the industrial debtor countries and brought their Governments on the verge of bankruptcy.

There had been indeed a few but brief occasions when some slackening in the rate of decline was visible, but in May 1931 a *financial panic* began which was to shake even the most strongly organised countries and drive a great number off the international gold standard. The first staggering blow fell on Austria. A large Austrian Bank collapsed due to its deeply committed industrial investments. This bank was the Creditanstalt. The news of this collapse travelled round the world's financial centres like a 'seismic shock' and brought about the instant realization, that, not only other banks in Austria and foreign countries, but virtually, the whole industrial structure of Austria and other Eastern European countries would be involved. Of the neighbouring debtor States the first to be exposed to the danger of panic withdrawals of capital was naturally Germany.

In order to avert a breakdown of the banking system, the Austrian Government was forced to guarantee all deposits of the bank. In this operation it was assisted by advances from the Bank of England and the Bank for International Settlements. For the time being the situation in Austria was saved, but the storm-centre shifted first to Germany. A very serious run began

on the Reichsbank which had already suffered a similar run a few months ago. This was followed by a run on the other banks of the country. An international effort was made to save the situation. The first relief was given by the President of the United States who announced on the 20th June one year's moratorium of reparation and war-debt payments. Besides, huge credits were granted to the Reichsbank by the Bank for International Settlements and the Central banking institutions of the U.S.A., England and France. But the revelation of financial weakness in Central Europe had created such a panic among investors and holders of short-term balances that the drain seriously continued. However, an international conference was held in London to save both Austria and Germany and thereby practically the world from utter collapse and " standstill " agreements were arranged for the continuation of large credits to Austria and Germany. As the result of these emergency measures, the danger of imminent collapse in these two countries seemed to have been tided over.

(*b*) ENGLAND GOES OFF THE GOLD STANDARD :—But it was now Great Britain's turn to stand the strain. In the first place, since 1920 Great Britain's balance of trade was growing steadily worse and for the years 1928-30 the excess of imports over exports had increased by £30 millions and the invisible items showed a loss of nearly £65 millions. So that the net credit balance on external transactions had been diminished by £95 millions. For the first time in her history Great Britain was faced with the possibility of a balance of payments against her. In 1931 the adverse balance against the country was £113,000,000 and the Chancellor of the Exchequer painted a disastrous picture of the country's financial position.

Secondly, on 31st July the May Committee published its report upon the condition of the public finances, and for the first time it was realised that Great Britain would have to face a large deficit estimated at £120 millions. The Cabinet disagreed on proposals to balance the budget, and on 24th August the National Government was formed. Ruthless economy was introduced and a supplementary budget imposed heavier taxation on 10th September.

Thirdly, Great Britain's difficulties were connected both with Germany's and with those of Central Europe, which were very much aggravated by the run on German banks. The British

banks had lent, not only Germany, but other Central European countries, a large amount of *short-term credit*. The sum lent to Germany alone amounted to £70 millions. In normal times these sums lent on short-term account would have been withdrawn in London. But before this could be done, a financial crisis, as stated previously, had supervened in Austria, Germany and other countries. Consequently, these short-term assets of England in these foreign countries became '*frozen*' by the inability of these countries to meet their foreign obligations and great uneasiness was created in England when the MacMillan Committee pointed out the magnitude of the sums lent.

Fourthly, the difficulty that had come upon England was mainly due to England's position as the international banking centre of the world. Sir George Schuster lucidly explained the position as follows : "London was the market where funds were most steadily raised and where deposits could be most readily realised. Everybody engaged in international trade liked to have a balance in London. The result was that London held enormous sums of foreign balances. During the period when the French franc was depreciating from 25 and 125, enormous quantities of French capital were exported to and held in London. That put London, in a sense, in the position of being at the mercy of those depositors who held deposits there and who, if their confidence was shaken in any way, could withdraw their deposits."* That was what exactly happened. France, the Netherlands, Belgium, Switzerland and other countries *started withdrawing their floating balances from London*. So that, with frozen assets on one side and a sudden run on deposits on the other, London was suddenly put in the position of a bank which had a *run* on it. The run on London rose to extraordinary proportions. Between Wednesday morning, 16th September, and Saturday mid-day, the 19th, over £43 million of short-term funds were withdrawn.

The Bank of England made tremendous efforts to create confidence by shipping gold to the countries withdrawing the balances. The withdrawals were partly met from gold and foreign money in the Bank of England and partly from credits secured by the Bank and the Government from New York and Paris. But in the week preceding 20th September, the withdrawals had

* In his speech on 26th September 1931, before the Legislative Assembly: *Legislative Assembly Debates*, page 1095.

so rapidly increased that the gold holding of the Bank had dropped to the low figure of £13 millions. No nation could stand such demands and continue to make payments in gold without endangering its financial existence. On 21st September, therefore, legislation was passed *suspending the Bank of England's obligation to sell gold.* By this momentous decision, Great Britain went off the Gold Standard temporarily and her standard became the Sterling Standard.

Lastly, apart from these factors responsible for taking the country off the Gold Standard, there may have been a deliberate move to depreciate the £. " The suspension of the Gold Standard is, in a figure, Nature's way of rectifying a prolonged adverse balance of international payments."* For, in terms of the depreciated national currency, the world price of the country's exports is lowered and at the same time the price of the country's imports is raised. By this artificial means a stimulus is given to the country's exports, whereas a discouragement is given to its imports. Besides, by the suspension of the Gold Standard, the Government gets the power to inflate paper currency to raise prices, as there is no compulsion on the part of the Government to keep gold as backing in the Reserve stipulated by law.

The repercussions of Great Britain's action in going off gold and the consequent fall of the £ by nearly 30 per cent. was immediately serious. Every creditor or debtor in any country who held British or foreign contracts in terms of sterling and all traders in the British market were immediately affected. Great Britain's action was almost simultaneously followed by a similar action in the Scandinavian countries of Denmark, Norway and Sweden, by Egypt and by practically the whole of the British Empire with the exception of South Africa and Canada, the latter maintaining an intermediate position between gold and sterling.

(*c*) LINKING THE RUPEE TO STERLING AND INSTITUTION OF EXCHANGE CONTROL :—On 21st September the British Government announced the decision to abandon the gold standard temporarily. As the Government of India did not receive information of this decision until the morning of the 21st September, prompt action was necessary in order to prevent panic and to avoid depletion of the sterling reserves. Ordinance

* *A Critique of the Gold Standard,* H. L. Puxley, page 126.

No. VI of 1931 was issued relieving Government from their obligation under the Currency Act to sell gold or sterling, and the three days, 22nd-24th September, were declared public holidays.

However, the decision to link the Rupee to Sterling at 1*s*. 6*d*. was announced on the 24th September and Ordinance No. VII of 1931 was issued which cancelled the previous Ordinance and instituted a control over the exchange. It limited sales of gold or sterling by Government to finance required by recognised banks for certain purposes only. However, the exchange restrictions did not prove to be necessary and as a consequence this second Ordinance was repealed by another Ordinance on 30th January 1932. Thus by executive action the Rupee was delinked from gold and linked to paper-sterling at the rate of 1*s*. 6*d*. and is in practice fluctuating between 1*s*. $5\frac{3}{4}d$. and 1*s*. $6\frac{3}{16}d$. as regulated by the executive action of the Controller of the Currency.

In support of the new sterling link Sir George Schuster, the Finance Member, placed before the Legislative Assembly* various advantages. In his own words, "and I do ask of Honourable members to weigh this in their minds. What would have been the risks of entirely detaching the Rupee from any sort of stable basis, and how do those risks compare with the present position when we have retained at least some anchor, some link to the comparatively stable basis of sterling." Then again, "A great deal has been made of the danger to our reserves if we continue on the course which we have taken, but . . . what would have been the position in the contrary case ? We have very heavy recurring sterling obligations to meet. Our actual sterling obligations are something like 32 millions every year. We have, moreover, on the 1st January 1932, a sterling loan of 15 million pounds maturing, and another of 7 millions later in the year. If we were entirely detached from any stable basis, I venture to say that our difficulties in raising money abroad, either in London or elsewhere, would be almost insuperable. We should then be forced back on to drawing on our sacred reserves in order to meet our recurring obligations. . . . Besides, we had the definite guarantee of assistance from His Majesty's Government both to meet our sterling recurring obli-

* His speech on 26th September 1931: *Legislative Assembly Debate.*

gations and to maintain the level of the Rupee. . . . For us to be linked with sterling has special advantages, because all our external obligations are in terms of sterling. I quite agree that as regards foreign trade, the trade done in sterling with England only represents a portion of India's total trade. But although it is only a portion, it is a very important portion and to have one important portion of foreign trade conducted on a stable basis without fluctuations of currency is an enormous advantage." (Read Chapter IX for other factors necessitating the sterling link.)

(*d*) UNPRECEDENTED EXPORTS OF GOLD FROM INDIA :—The immediate result of the suspension of the gold standard by Great Britain was a depreciation of sterling to its natural level, and as the pound sterling went on depreciating it brought about a constant *appreciation* in the price of gold. With many other countries going off gold, *the premium on gold increased*. There was obviously a widespread expectation at that time that gold would continue to be used for monetary purposes, and possibly at higher commodity values resulting from currency devaluation in many countries. This was re-affirmed by the Report of a Committee appointed by the Monetary and Economic Conference in June 1933, which stated that "gold should be re-established as the international measure of exchange values, time and parity being for each country to determine." As a consequence there was an increased demand for gold from most countries whether on the gold standard or not.

It should be added, moreover, that the effect of the under-valuation of sterling upon world price levels was immense. It accentuated the falling trend of commodity-prices. This was due in part to the fact that "since Great Britain is the principal buyer and consumer of many commodities, the decline of her external purchasing power through the depreciation of the pound sterling was bound to affect the world's commodity markets."* This effect was all the stronger because in a period of depression it is the buyers rather than sellers who determine prices. What was true in the case of Great Britain was also true of those other countries which went off gold and deliberately depreciated their currencies. The consequence of this accentuation in the fall of commodity-prices was a greater appreciation in the value

* Paul Einzig: *The Sterling-Dollar-Franc Tangle*, page 44.

of gold.

Mention was also made in a previous chapter of the policy of certain countries like France in buying up gold from various countries and hoarding it in their respective Central Banks. A gradual concentration of the gold stocks of the world into Central Bank reserves was taking place till about the middle of 1931. But at that time a new disturbing factor arose. Fear of *currency instability* which was becoming widespread and which was dramatically confirmed by the depreciation of sterling in September, led to *hoarding* of gold on a large scale in various Western countries, particularly in Western Europe and the United States of America.* This factor accelerated the demand for gold and brought about a still greater rise in its price.

Yet another factor which was responsible for the rise in the price of gold was the London-New York cross-rate. As sterling fell in relation to the dollar, more sterling had to be paid for buying a greater quantity of gold than before ; but on the contrary, if the dollar fell in relation to sterling, the price of gold correspondingly fell. Thus when the London-New York cross-rate (dollars to pound sterling) in 1931-32 was highest 4.86 $\frac{21}{32}$ the price of gold in London was £4 4*s*. 11½*d*. and when it was lowest 3.25¾ the price of gold was £6 8*s*. 9*d*. Similarly, in 1932-33 when the cross-rate was highest 3.80¼ the price of gold in London was £5 13*s*. 5*d*. and when it was lowest 3.15⅛ the price of gold was £6 9*s*. 3½*d*. The price of gold in London rose from £4 4*s*. 10¾*d*. in April 1931 to £8 8*s*. the highest, in 1939-40.

The rapid increase in the price of gold had its influence on gold holding in India. It not only stimulated the movement of gold which was already in existence, but induced those who had hoarded the metal to take advantage of the premium on gold to sell. The sale of gold became a profitable business and bullion dealers all over the country became very active in collecting gold for sale to the export market and in some districts special purchasing agencies were opened by exporters. Gold, therefore, began to move out of India in unprecedented quantities and a country which was normally receiving large quantities of the metal became now an exporter of it. Statement VIII shows the

* "It may be indirectly estimated that the total 'other monetary gold stocks' which in June 1931 was about 700 million dollars had increased at the end of 1932 to roughly 1,250 to 1,300 million dollars, mainly on account of private hoarding in Europe and North America." The Bank of International Settlements, Third Annual Report.

extent of the out-flow of gold.

STATEMENT VIII

AVERAGE VALUE OF IMPORTS AND EXPORTS OF GOLD COIN AND BULLION

	NET IMPORTS OR EXPORTS IMPORTS + EXPORTS —
AVERAGE OF	Rs.
1920-21 to 1924-25... ...	28,70,95,282
1929-30	14,22,08,396
1930-31	12,75,32,115
1931-32	-57,97,27,842
1932-33	-65,52,27,956
1933-34	-89,56,32,418
1934-35	-52,53,74,607
1935-36	-37,35,58,955
1936-37	-27,84,61,129
1937-38	-17,90,02,290
1938-39	-23,26,02,068

The exports of gold continued upto the outbreak of World War II when exports of precious metals were banned.

There had been a considerable controversy as to whether the gold exported since October 1931 had been mostly *"distress"* gold, or whether it had been gold which was being sold as a business proposition to realise the profit to be obtained from the rise in the price of gold. By "distress" gold is meant that gold which an individual is compelled to sell during times of stress or necessity in order to meet his current expenses. The indication of the sale of "distress" gold was to be found in the *collapse of agricultural prices.* As compared to January 1929, *the decline of agricultural prices in India measured in gold was* 56.4 per cent. in March 1933. The fall in agricultural prices was not accompanied by a comparable reduction in the cost of agricultural production. Many of these costs were fixed by con-

tract over a long term of years. In a time of depression, interest upon mortgage indebtedness, railway freights and charges for current expenses do not fall quickly. Labour costs fall more slowly than prices, and the prices paid for materials are maintained at higher levels than those which the farmer must accept. Under the circumstances the farmer is compelled to sell off his hoarded wealth to meet his current expenses. Besides, as credit dries up in times of distress, all his requirements must be paid for in cash. Gold or gold ornaments, if any, must, therefore, be sold off to obtain cash, that is, local currency. But with the fall in the purchasing power of the agriculturist due to the collapse in prices, commerce, trade and industry must also be adversely affected, although not to the same extent as in the case of agriculture. Distress must spread over these other constituents also.

Another indication of distress was noticeable in the *heavy decline in the exports* of India which consist mainly of the stable agricultural products. How these had suffered during succeeding three years would be obvious from Statement IX consisting of a few typical products selected for the purpose.

STATEMENT IX

EXPORTS FOR THE YEAR

(In lakhs of Rupees)

	1929-30	1930-31	1931-32	1932-33
Rice	31,50	25,81	17,88	14,22
Wheat	21	1,94	15	13
Seeds	26,46	17,86	14,58	9,34
Jute (raw) ...	27,17	12,88	11,18	9,37
Cotton (raw) ...	65,22	46,32	23,44	17,37

Moreover, statistics of the exports and imports of merchandise as a whole demonstrate the trend of foreign trade and indicate the extent of depression in trade within the country. Statement X shows how exports had fallen catastrophically as compared to imports.

STATEMENT X

THE TREND OF FOREIGN TRADE IN MERCHANDISE

	1925-26	1929-30	1930-31	1931-32	1932-33
Exports ...	100	83	60	42	35
Imports ...	100	107	73	56	60

(*e*) BALANCE OF TRADE AND EXCHANGE :—Reference was made above to the heavy drop in India's exports of merchandise. This was due not only to the continued fall in prices but to the decline in trade and the purchasing power of the countries which imported from India, and this was aggravated in several cases, by these countries remaining on the gold standard, and in others, as in Europe, by their attempts to bolster up their tottering exchanges by elaborate systems of control which made trade almost impossible. As a result India's balance of trade in merchandise fell heavily. Statement XI shows the catastrophic decline in India's favourable balance of trade.

STATEMENT XI

BALANCE OF TRADE

	In crores of Rupees
1930-31	+ 62
1931-32	+ 34.83
1932-33	+ 3.38

The favourable trade balance recorded in **1932-33** was the lowest since **1922-23**. It is obvious that in the circumstances India would have been unable to meet her external commitments without drawing on her reserves *if there had not been the huge exports of gold*. The sellers of gold drew export bills in sterling on their constituents in England and the Government could purchase such bills for making their remittances to the

Secretary of State. Besides, as trade was dull in 1931-32 the Government had to *sell Reverse Councils* from time to time to maintain the rate of exchange at the lower gold point. The total amount of such sales amounted to nearly Rs. 19 crores. The abandonment of the gold standard by the British Government on the 21st September enabled the Government of India to purchase a large amount of remittance and also gave strength to the exchange which never fell below 1*s*. $6\frac{3}{32}$*d*.

During 1932-33 trade was very dull but the large exports of gold, on the one hand, enabled the Government to purchase enough sterling, and on the other gave strength to the exchange. The only disquieting feature appeared on 6th March 1933, when the United States of America temporarily prohibited the export of gold and dealings in foreign exchange. The uncertainty and uneasiness created thereby led to an immediate and precipitate fall in the rupee sterling exchange from 1*s*. $6\frac{3}{32}$*d*. to 1*s*. $5\frac{7}{8}$*d*. But within a few days confidence was restored and the rate rose to 1*s*. $6\frac{3}{16}$*d*.

Mention must also be made of the fact that the *dishoarding* of gold in India had a very healthy effect on the country's industrial development. The sales of gold resulted in growing liquid Rupee funds which induced the formation of several companies during the succeeding seven years. Thus, many electrical companies, sugar companies, chemical companies, match companies, cigarette companies and others, were started, which bore testimony to the productive use to which gold was put in India. Besides, we were able to finance the great building boom in the principal cities of India.

(*f*) THE TURNING POINT IN INDIA'S TRADE RECOVERY :—Evidently, the turning point in world trade recovery came when England went off gold and thereby the *deflationary tendencies began to be checked*. England was followed by several other countries who also shook off the Gold Standard and formed, as stated in Chapter IX, the Sterling Area Group. The movement gathered strength with the abandonment of their old levels by the United States of America in 1933 and by the "Gold Bloc" countries going off gold in 1936. Finally, when the Tripartite Monetary Agreement between the United States of America, Great Britain and France came into action to

give stability to world's currencies, world trade began to recover very fast until World War II broke out.

The recovery in the world took the form of a larger demand for raw materials in the industrial countries and of greater imports of capital goods by agricultural countries. As a consequence, India's foreign trade began to prosper once again. As stated above, India's continuous large sales of gold to foreign countries resulted in growing liquid Rupee funds which induced large purchases of capital goods abroad for developing Indian industries. At the same time, India's exports of raw materials such as raw jute, raw cotton, raw hides and skins and seeds registered a steady increase upto the end of 1936-37. India's Balance of Trade again recovered as shown in Statement XII.

STATEMENT XII

INDIA'S FAVOURABLE BALANCE OF TRADE

(In crores of Rupees)

1934-35	1935-36	1936-37	1937-38	1938-39	1939-40
			(India only)	(India only)	(India only)
20.42	29.37	79.51	30.90	17.39	48.90

The figures for 1937-38 and succeeding years do not include the figures for Burma, because that country was separated. In 1937-38, the fall in the Balance of Trade was largely due to reduced exports of raw cotton. This commodity was most closely dependent on American prices and as there was a slump in the American market, India's cotton exports were adversely affected. But India's exports were on the whole hard hit during the years 1937-38 and 1938-39, because of the shrinkage in world trade due chiefly to factors such as barter agreements and methods of Exchange Control which were vigorously introduced by many European countries bent on economic nationalism. The improvement in 1939-40 was mainly due to large purchases made in India by the United Kingdom and the United States of America on the advent of the war.